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No. _____

IN THE
SUPREME COURT OF THE UNITED STATES

Summer Term, 1981

SMITH BARNEY, HARRIS
UPHAM & CO., INC.,

Petitioner,

v.

WENDEE HENRICKSEN,

Respondent.

On Writ of Certiorari
To the United States Court of Appeals
For the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Under the Securities Exchange Act of 1934 ("the Act"), may absolute liability be imposed on a "controlling person" for losses resulting from violations of the Act by a controlled person, abrogating the "good faith" defense of Section 20(a) of the Act by applying the common law doctrine of *respondeat superior?*

2. Does the "scienter" requirement of *Ernst & Ernst v. Hochfelder* permit the imposition of secondary liability on a controlling person, under Section 20(a) of the Act, without regard to fault?

3. Does the "scienter" requirement of *Ernst & Ernst v. Hochfelder* permit the imposition of secondary liability on a controlling person, under Section 20(a) of the Act, where that person did not act recklessly or with intent to deceive, manipulate or defraud?

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PETITION FOR WRIT OF CERTIORARI

The petitioner, Smith Barney, Harris Upham & Co., Inc. ("Smith Barney"), prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit, entered in this action on February 6, 1981.

OPINIONS BELOW

The decision and order of the court of appeals, dated February 6, 1981, is reported at 640 F.2d 880, Fed. Sec. L. Rep. (CCH) ¶97,859, and reproduced in the Appendix to this petition, *infra,* at A-1 *et seq.*

The decision and order of the United States District Court for the Eastern District of Wisconsin, dated March 10, 1980, is reported at 486 F.Supp. 622, Fed. Sec. L. Rep. (CCH) ¶97,374, and reproduced in the Appendix to this petition, *infra*, at D-1 *et seq*.

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on February 6, 1981. A timely petition for rehearing was denied on March 30, 1981, and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

1. Section 15 of the Securities Act of 1933, as amended, 15 U.S.C. §77*o*, provides:

> **Liability of controlling persons**
>
> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

2. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), provides:

Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5, provides:

Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78t(a), provides:

> **Liabilities of controlling persons**
>
> (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

STATEMENT OF THE CASE

By enacting §20(a) of the Securities Exchange Act of 1934 (the "Act"), 15 U.S.C. §78t(a), Congress expressly rejected strict or "insurer's" liability as the standard under which "controlling persons" may be held secondarily liable for violative acts and omissions of their agents. Instead, Congress chose a "fiduciary" standard, under which a "controlling person" (here, Smith Barney, a broker-dealer registered under the Act) has no liability if it "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation...." In this action arising under sections 10(b) (15 U.S.C. §78j(b)) and 20(a) of the Act, the court of appeals imposed liability on Smith Barney under a common law theory of *respondeat superior*, notwithstanding the district court's findings that Smith Barney acted in good faith and did not directly or indirectly induce the violation.[1]

The circuits are in conflict on the question whether secondary liability for violations of the Act may be imposed under the common law doctrine of *respondeat superior*. In those circuits

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[1] See note 3, *infra* at p. 6 and appended text.

where *respondeat superior* liability is recognized, controlling persons are denied the "good faith" defense available under §20(a). Absent resolution of this conflict, the nation's broker-dealers will continue to be held accountable by different and unpredictable standards in the respective circuits where they transact business.

Moreover, the court of appeals' imposition on Smith Barney of derivative liability under §10(b), despite Smith Barney's "good faith," is plainly inconsistent with this Court's holding in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), that liability under §10(b) does not arise in the absence of "scienter," defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 194, n. 12. This inconsistency, a recurring problem in the application of §20(a), presents — starkly in this case — an important federal question which this Court should resolve.

After a three-day bench trial the district court found that plaintiff-respondent Wendee Henricksen's husband, George Henricksen, while employed by Smith Barney as a stockbroker, (1) lost $33,564.31 of his wife's money in unauthorized options trading ("options trading losses"), and (2) defrauded her of $55,356.91 more in cash, as checks drawn on Smith Barney's account payable to Wendee were delivered to George, endorsed by him for deposit in a joint savings account the Henricksens maintained at a Milwaukee bank, and subsequently withdrawn as cash from that account ("withdrawal losses").[2] The trial court concluded that George Henricksen violated §10(b) and was liable to Wendee for $110,675.87, an amount equal to: (1) the withdrawal losses; (2) the options trading losses; (3) the commissions on all transactions in Wendee's account during 1976 and 1977; and (4) the interest earned during the same period on sums Wendee borrowed from Smith Barney through her margin account.

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[2]$43,825.57 passed through the savings account. The balance ($11,531.34) did not, and how it disappeared was not developed at trial.

The trial court concluded that Smith Barney was liable for the commissions and interest but had no liability for either the $33,564.31 in options losses or the $55,356.91 in withdrawal losses. The court found that Smith Barney was reasonably diligent in supervising both the withdrawals from and the quality of trading in Wendee's account, and that the withdrawal and options trading losses were "not due to any failure on Smith Barney's part to enforce with reasonable diligence its internal plan of supervision." (App. at D-19). Therefore, Smith Barney acted in "good faith," did not "directly or indirectly induce the violation,"[1] and so could not be liable under §20(a) of the Securities Exchange Act of 1934.

The trial court carefully determined whether, as a matter of fact, strict compliance with reasonable supervisory procedures would have prevented George from defrauding Wendee by withdrawing funds from their joint savings account. The court found that Wendee would not have examined Smith Barney statements or checks even if they had been sent to her home (App. at D-9, 19); that George had sweeping powers of attorney which authorized him to endorse checks made payable to Wendee (App. at D-2, 4-5, 22); that the checks were in fact deposited in Wendee's account, pursuant to a conservative investment plan which was "plausible" in view of market conditions (App. at D-19, 21); that two Smith Barney managers questioned George about, and received a plausible explanation for, his arranging to have the checks delivered to his office (App. at D-6, 19); and that this practice, as authorized by Rule 409(b)(2) of the New York Stock Exchange, is common and accepted within the industry (App. at D-19).

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[1]The courts have defined lack of "good faith" in the §20(a) context as the failure to "maintain a reasonably adequate system of internal supervision and control . . . or [to] enforce with any reasonable diligence such system but on the contrary indirectly induc[ing], participat[ing] in or approv[ing] and accept[ing] the benefits [of the violations alleged]...." *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1051 (7th Cir. 1974). *Accord, Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1120 (5th Cir. 1980); *S.E.C. v. Geon Industries, Inc.*, 531 F.2d 39, 51-54 (2d Cir. 1976); *Zweig v. Hearst Corporation*, 521 F.2d 1129, 1134-35 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975).

George was able to defraud Wendee simply because, as her husband he was able to withdraw funds from their joint savings account. As far as Smith Barney was concerned, their representative did precisely what he should have done with checks drawn payable to Wendee: he deposited them in her account. What he did after deposit was beyond Smith Barney's capacity to supervise.

The court of appeals somewhat grudgingly acceded to the trial court's logic: "It cannot be known with certainty that George's conversion of withdrawals would have been *deterred or detected and stopped* by a review of Wendee's account...." (emphasis added). (App. at A-13). The court of appeals nevertheless reversed the district court, holding Smith Barney liable in damages for all of the options trading and withdrawal losses.

The court of appeals divided the withdrawal losses into two categories. It first determined that, according to Smith Barney's Compliance Manual, the branch managers should have reviewed Wendee's account during (but not before) November 1976. Smith Barney was held liable for the November 1976 through October 1977 withdrawal losses ($15,635.80) under §20(a). The court thus held that a broker-dealer may "induce" a violation of §10(b) by simply failing to detect and prevent the violation.

Beyond that, the court of appeals held Smith Barney liable for the pre-November 1976 withdrawal losses ($39,721.11), even though concededly adequate supervision would not have triggered a review for their detection or prevention. The court of appeals thus imposed secondary liability without fault. Where mere negligence does not suffice for primary liability, and where Congress has enacted a "good faith" defense to secondary liability, Smith Barney has been held secondarily liable, without negligence, for an injury which it could not have prevented.

REASONS FOR GRANTING THE WRIT

I. Review By This Court Is Required To Resolve The Conflict Between Circuits On The Question Whether The Common Law Doctrine Of *Respondeat Superior* May Impose Secondary Liability On Broker-Dealers For Violations Of The Federal Securities Laws.

The court of appeals based Smith Barney's liability for $39,721.11 of the withdrawal losses solely upon the common law doctrine of *respondeat superior.* The court articulated this doctrine as follows:

> "Under common law principles, a principal is liable for the deceit of its agent committed in the very business he was appointed to carry out.[4] This is true even though the latter's specific conduct was carried on without knowledge of the principal" [quoting from *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1051 (7th Cir. 1974)]. (App. at A-13).

The circuits are divided on the issue whether this doctrine may create secondary liability for violations of the federal securities laws. The Second, Fifth, Sixth and Seventh Circuits have held or implied that *respondeat superior* is available to plaintiffs proceeding under the federal securities laws. *Marbury Management, Inc. v. Kohn,* 629 F.2d 705 (2d Cir.), *cert. denied,* 101 S.Ct. 566, 66 L.Ed. 2d 469 (1980); *Paul F. Newton & Co. v. Texas Commerce Bank,* 630 F.2d 1111 (5th Cir. 1980); *Holloway v. Howerdd,* 536 F.2d 690 (6th Cir. 1976); *Fey v.*

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[4]The appeals court held Smith Barney liable for George's fraud without any analysis or finding that his wrongful acts were committed in the course of the business he was appointed to carry out for Smith Barney. The court simply ignored the fact that George withdrew the funds as Wendee's husband, not as Smith Barney's representative. Absent such a finding, no liability may properly be imposed under *respondeat superior.* Smith Barney's liability is indeed strict, since it is not authorized even by the doctrine upon which the court purports to have relied.

Walston & Co., Inc., 493 F.2d 1036 (7th Cir. 1974). The Third, Fourth, Eighth and Ninth Circuits have held or implied that the statutory "controlling person" provisions are the exclusive standard for establishing secondary liability. *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975);[3] *Carpenter v. Harris, Upham & Co., Inc.*, 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979);[4] *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Christoffel v. E. F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978). Only review by this Court can resolve these flatly contradictory interpretations of the same federal statute.

By enacting §20(a) Congress defined the conditions under which a controlling person (here a broker-dealer) may be held liable for damages resulting from violation of the Securities Exchange Act of 1934 by a controlled person (here, a registered representative). Congress defined the conditions of secondary liability to preclude liability where "...the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

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[3]The Third Circuit has recently recognized a limited exception to the *Rochez* rule that *respondeat superior* is inapplicable to controlling person liability. *Sharp v. Coopers & Lybrand*, Fed. Sec. L. Rep. (CCH) ¶97,971 (3rd Cir. 1981), involved an accounting firm's §10(b) liability for material misrepresentations contained in a tax opinion letter. The letter had been reviewed by a partner of the firm, signed in the name of the firm and released with full knowledge that it would be presented to and relied upon by potential investors. Though conceding that *respondeat superior* liability could be imposed in the special circumstances of this case, the court placed primary emphasis on the *firm's* direct participation in the preparation of the letter.

[4]In a case decided before this Court's ruling in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Fourth Circuit Court of Appeals had implied that *respondeat superior* was applicable to determine secondary liability for violations of the federal securities laws. *Johns Hopkins University v. Hutton*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974). In *Carpenter*, however, the Fourth Circuit held that secondary liability of broker-dealers requires a showing of scienter under §20(a). *Carpenter* has been interpreted as having overruled *Johns Hopkins sub silentio*. *Haynes v. Anderson & Strudwick, Inc.*, 508 F.Supp. 1303 (E.D. Va. 1981).

Under the Securities Act of 1933, controlling person liability had been absolute. Without qualification, a controlling person was liable for controlled persons' violations of the 1933 Act. 15 U.S.C. §77*o* (1933) (amended 1934). When the 1934 Act was enacted, however, the 1933 Act was amended (Act of June 6, 1934, c. 404, §208, 48 Stat. 908) to make it clear that mere "control" is not sufficient for secondary liability. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 42 (1934). The legislative intent, apparent from the terms of §20(a) and the 1934 amendment to §15, limits secondary liability to situations where the controlling person is causally and culpably responsible for the third party's loss. As the Third Circuit Court of Appeals has observed:

> The legislative history of Section 20(a) illustrates that Congress intended liability to be based on something besides control. That something is culpable participation.

Rochez Brothers, Inc. v. Rhoades, supra, at 884-85. *Accord, Carpenter v. Harris, Upham & Co., supra.* This view comports with the legislative history relating to the general duties of controlling persons:

> Legislative history reveals that the Senate and the House had advocated different versions of the standard that should govern controlling persons. The House proposed that the standard should be a "fiduciary standard," which would require a duty of due care. (H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933); H.R. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933).) On the other hand, the Senate proposed an "insurer's liability" (S.Rep. No. 47, 73d Cong., 1st Sess. 5 (1933), the Fletcher Report). Congress enacted the House version, rejecting the insurer concept.

Christoffel v. E. F. Hutton & Co., Inc., 588 F.2d 665, 668 (9th Cir. 1978). In this context, it is clear that Congress has expressly rejected a standard which, like *respondeat superior,* would

make controlling persons strictly liable for the violations of controlled persons.

The "good faith" defense to secondary liability, deliberately conferred upon controlling persons by Congress, cannot co-exist with common law liability under *respondeat superior.* Under §20(a), the controlling person has a defense to secondary liability if it shows that it acted in good faith and did not *induce* the violation. At common law, this showing is no defense to *respondeat superior* liability. Permitting recovery under *respondeat superior* for 1934 Act violations thus abrogates §20(a).

Review by this Court is necessary to rectify this judicial abrogation of statutory law and to resolve the existing conflict between circuits on this issue.

II. The Existence Of Strict Secondary Liability, Created And Imposed By The Court Below, Conflicts With The Principles Of *Ernst & Ernst v. Hochfelder* And Constitutes An Important Question Of Federal Law Which Should Be Addressed By This Court.

The court below held Smith Barney strictly liable for the pre-November 1976 ($39,721.11) withdrawal losses without a finding of negligence or causation. The court found that Smith Barney could and should have prevented subsequent withdrawal losses ($15,635.80) by discharging its duty of adequate supervision. With respect to the latter, Smith Barney was liable upon a finding of simple negligence. Both of these results are inconsistent with this Court's holding in *Ernst & Ernst v.*

Hochfelder, supra, that §10(b) liability requires a showing of scienter.[7]

The facts of this case are much like the facts in *Ernst & Ernst v. Hochfelder, supra.* In that case, a stockbroker fraudulently converted plaintiffs' funds to his own use. Plaintiffs sued Ernst & Ernst under §10(b), alleging that it should have discovered certain business practices, the discovery and disclosure of which would have led to a complete audit and thus to the detection and prevention of the conversions. The Seventh Circuit Court of Appeals held that liability for the conversion losses under §10(b) could be imposed upon Ernst & Ernst if negligence were shown; *i.e.,* that Ernst & Ernst had a "duty of inquiry" and that the failure to discharge this duty caused plaintiffs' loss. *Id.* at 191. Informed by the legislative history of §10(b), this Court reversed, holding that §10(b) liability does not arise in the absence of an "intent to deceive, manipulate, or defraud." *Id.* at 193.

With respect to the post-November 1976 withdrawal losses, the court of appeals has held Smith Barney liable on a finding of

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[7]In *Ernst & Ernst v. Hochfelder, supra,* this Court defined scienter as follows:

> In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5.

Id. at 194, n.12. In subsequent cases, some courts have held that where there exists a fiduciary relationship between the plaintiff and defendant, recklessness may satisfy the scienter requirement. *See, e.g., Edwards & Hanley v. Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 484-85 (2d Cir. 1979), *cert. denied,* 444 U.S. 1045 (1980). Where the recklessness standard is applied, however, more than negligence is required. *See, e.g., Broad v. Rockwell International Corp.*, 614 F.2d 418, 440 (5th Cir. 1980); *Sanders v. John Nuveen & Co., Inc.*, 554 F.2d 790, 792-93 (7th Cir. 1977), *cert. denied,* 68 L.Ed.2d 210 (1981).

simple negligence — that these losses would have been detected or deterred if Smith Barney had satisfied its "duty of adequate supervison" (App. at A-13). In spite of the plain terms of §20(a), which the *Ernst & Ernst* court cited as an example of Congress' ability to restrict recovery with respect to specific types of securities claims (*see Id.* at 209, n. 28), and in derogation of this Court's analysis and ruling in *Ernst & Ernst*, Smith Barney has been held liable under §10(b) for omissions which were, at worst, merely negligent.

With respect to the pre-November 1976 withdrawal losses, the court of appeals' disregard of *Ernst & Ernst* is far more dramatic. Smith Barney was held liable for these losses *without* a finding that they would have been "detected or deterred" if Smith Barney had discharged its duty of adequate supervision. In fact, since the court found that November 1976 was the time when Smith Barney first had a duty to review Wendee's account, Smith Barney did not breach its duty of supervision until November 1976. In this case, the Seventh Circuit Court of Appeals has thus gone far beyond what it was reversed for doing in *Ernst & Ernst:* it has created strict liability under §10(b).[9] In terms applicable to this case in all respects, the *Ernst & Ernst* Court forcefully rejected this proposed expansion of statutory liability:

> In support of its view, the Commission cites the overall congressional purpose in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them.... The Commission then reasons that since the "effect" upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm

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[9]See note 4, *supra* at p. 8.

> to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning.... The argument simply ignores the use of the words "manipulative," "device," and "contrivance" — terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. [Citations omitted].

Id. at 198-99.

An "effect-oriented" standard of liability was applied here despite *Ernst & Ernst.* The results are truly incongruous. Although scienter is required for §10(b) liability, Smith Barney is liable without negligence. A "controlling person" is not liable unless it induces the violation, but Smith Barney is liable even though it could not have prevented the violation.

The imposition of strict §10(b) liability upon a control person is an important federal question which has not been, but should be, directly addressed by this Court. Review by this Court is required to vindicate the principles articulated in *Ernst & Ernst v. Hochfelder, supra,* and to define the standard applicable to broker-dealer liability for the §10(b) violations of its registered representatives.

III. Whether "Controlling Person" Liability May Be Imposed Under §20(a) For Failure To Maintain And Diligently Enforce A Reasonable System Of Internal Supervision Is An Important Question Of Federal Law Which Has Not Been, But Should Be, Reviewed By This Court, And With Respect To Which There Exists A Conflict Of Authority Between Circuits.

The court below held Smith Barney liable under §20(a) for George's post-November 1976 withdrawal losses ($15,635.80)

and for all of the option trading losses ($33,564.31). Following *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1051 (7th Cir. 1974), the court held that secondary liability under §20(a) arises where the control person fails to "maintain a reasonably adequate system of internal supervision and control" or fails to "enforce with any reasonable diligence such system...." (App. at A-8).

By its terms, §20(a) provides that a control person is *not* liable if it "act[s] in good faith" and does not "directly or indirectly induce the act or acts constituting the violation or cause of action." The terms of §20(a) thus suggest, as strongly as the terms of §10(b), a requirement of scienter. The control person must *induce* the violation; if the control person, in *good faith*, merely fails to prevent the violation, liability would not arise under the terms of the statute. The *Fey v. Walston* interpretation of §20(a), however, would impose liability for a mere breach of the "duty to supervise" which that decision implied and imposed.

The court of appeals made no attempt to define the content of the "duty to supervise" which formed the basis for its imposition of §20(a) liability. Nowhere in its opinion does the court state what the law requires for "adequate" supervision. The only standard applied to Smith Barney's conduct was the Smith Barney Compliance Manual ("the Manual"). The court of appeals thus equated Smith Barney's Manual and its legal duty of care. By employing this standard of care, the court of appeals held Smith Barney liable not only without scienter, but for something less than negligence. The Manual is designed to be more restrictive than existing legal requirements. It comprehensively incorporates similarly rigorous standards and procedures from outside the securities laws, including the rules of the New York Stock Exchange and the National Association of Securities Dealers. Because, by design, the Manual exceeds perceived legal requirements, it should not be held up as the

minimum standard of conduct under the federal securities laws.[9]

This Court should dispel the confusion which reigns in the circuits by defining a controlling person's duty of care under the scienter language of §20(a). Petitioners respectfully submit that, in view of the language which appears in both sections, §20(a) should be interpreted subject to the principles which this Court applied to §10(b) in *Ernst & Ernst v. Hochfelder, supra.* The Fourth Circuit has adopted this approach, concluding, in conflict with *Fey v. Walston, supra,* that simple negligence does not suffice for §20(a) liability. *Carpenter v. Harris, Upham & Co., Inc.,* 594 F.2d 388 (4th Cir.), *cert. denied,* 444 U.S. 868 (1979). There thus exists a split of authority between circuits as to the standard for determining liability under §20(a).

Review by this Court is required to resolve the split of authority on this issue, to authoritatively interpret §20(a) for the first time, and to expressly overrule decisions, such as *Fey v. Walston,* decided before, and inconsistent with, *Ernst & Ernst v. Hochfelder.*

CONCLUSION

A substantial portion of the judgment against Smith Barney was awarded even though the trial court found, and the court of appeals conceded, that the loss awarded could not have been prevented by Smith Barney's employment of adequate

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[9]Since the Manual incorporates N.Y.S.E. and N.A.S.D. rules, imposing liability under §20(a) for violation of the Manual tacitly recognizes a private right of action for violation of those rules. For the reason just suggested, it has been held that a broker-dealer's violation of such rules does not in itself give rise to a private cause of action. *E.g., Parsons v. Hornblower & Weeks—Hemphill, Noyes,* 447 F.Supp. 482 (M.D.N.C. 1977), *aff'd per curiam,* 571 F.2d 203 (4th Cir. 1978). The court of appeals' imposition of liability for George's options trading on an "unsuitability" theory conflicts with these cases.

supervisory procedures. The Seventh Circuit has thus held that, notwithstanding the statutory good faith defense, a plaintiff can sue under §10(b) and recover from a broker-dealer without proving either negligence or causation. In addition to abrogating the good faith defense of §20(a), this conflicts with the scienter requirement of *Ernst & Ernst v. Hochfelder*. Also in conflict with that decision, although less dramatically, was the imposition of liability for omissions which were, at worst, merely negligent. Certiorari should be granted to review, and to resolve the conflict between circuits concerning, these important federal questions.

Respectfully submitted,

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APPENDIX

In the
UNITED STATES COURT OF APPEALS
For the Seventh Circuit

Nos. 80-1488, 80-1584
WENDEE HENRICKSEN,

Plaintiff-Appellant,

v.

GEORGE HENRICKSEN and SMITH BARNEY, HARRIS, UPHAM & CO., INC.,

Defendants-Appellees.

Appeal from the United States District Court
for the Eastern District of Wisconsin.
No. 78-C-208—**Myron L. Gordon**, Judge.

ARGUED NOVEMBER 7, 1980-DECIDED FEBRUARY 6, 1981

Before CUMMINGS and WOOD, *Circuit Judges,* and CAMPBELL, *Senior District Judge.**

CUMMINGS, Circuit Judge. Plaintiff Wendee Henricksen (Wendee) brought this securities fraud action against her former husband, George Henricksen (George), a registered stockbroker, and his former employer, the investment firm of Smith Barney, Harris, Upham & Co., Inc. (Smith Barney). After a bench trial, the district court found George liable to Wendee in the amount of $88,921.22 plus interest and costs for conversion and fraudulent mismanagement of Wendee's account at Smith Barney. The court further found George and Smith Barney jointly and severally liable in the amount of $21,754.65 plus interest for commissions and margin expenses generated during

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*The Honorable William J. Campbell, Senior District Judge of the Northern District of Illinois, is sitting by designation.

George's mismanagement of the account. Wendee appeals from that portion of the judgment denying recovery against Smith Barney for the $88,921.22 plus interest and costs she lost through George's unlawful conduct. Smith Barney cross-appeals from the $21,754.65 judgment against it. We conclude that the district court erred in not finding Smith Barney liable for the total damages Wendee suffered and therefore reverse in part and affirm in part.

I

George and Wendee were married in August 1969. In 1970, the couple moved to Milwaukee, Wisconsin, where George went to work as a stockbroker at Smith Barney.[1] Wendee was employed as a third grade schoolteacher, but left teaching in 1973 when the couple's daughter was born.

At George's request, Wendee opened three discretionary accounts at Smith Barney—a regular account, an option account and a margin account—in June 1972, November 1975 and January 1976 respectively. A discretionary account is one in which the broker—in this case, the client's husband—is given discretion to conduct transactions without the client's prior approval. Accordingly, Wendee executed two powers of attorney, in June 1972 and November 1975 respectively, giving George complete discretion over the management of her Smith Barney accounts. According to the testimony at trial, Wendee had no interest in the details of her financial matters, did not understand the nature of option or margin trading, and never read any of the documents George gave her to sign in connection with the accounts.

A new account form filled out in June 1972 in accordance with the New York Stock Exchange "Know Your Customer" Rule listed Wendee's investment objective as "long-term

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[1] Smith Barney & Co., Inc. merged with Harris, Upham & Co. in February 1976.

growth of capital-income secondary," the second most conservative investment objective listed on the form.[2] As required by Smith Barney's internal rules, an option client information sheet and an option client approval sheet were prepared in connection with the opening of Wendee's option account. The option client information sheet, prepared and signed by George, indicated that Wendee's investment objective was "growth" as opposed to "income" or "speculation" and that the only type of option transaction anticipated was "covered writing."[3] The option client approval sheet, signed by the branch manager of Smith Barney's Milwaukee office, a registered options principal, and a member of Smith Barney's New York compliance section, stated that Wendee's was a discretionary account and that it was "Approved for covered writing transactions only" (Tr. 284). The option client information sheet prepared by George also indicated that Wendee's option account was a single, not a joint, account; that the client was a 28-year-old housewife with an annual income of $5,000 or less, a net worth of "100,000-250,000" and net assets of $123,000; and that her husband's annual income was $30,000.

The Smith Barney Compliance Manual provided that each order in a discretionary account had to be approved by the branch manager prior to the entry of the order, that the New York compliance section had to make a daily and monthly review of all discretionary account transactions, and that such approvals and reviews were to be made in light of the client's investment objectives. The Compliance Manual also provided that option transactions were to be approved only for clients having at least a $20,000 annual income and $20,000 of investment assets and then only for the categories of option trading approved on the option client approval sheet.

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[2] The choices on the form were: "Conservation of capital with stable income," "Long-term growth of capital—income secondary," "Moderate capital appreciation with reasonable income," "Short-term trading profits," and "Speculative capital gains" (Exhibit 17, Tr. 137).

[3] The forms of option trading not anticipated or approved for the account were: unsolicited transactions, purchasing calls, spreading, uncovered writing, and discretionary transactions (Exhibit 19, Tr. 205).

With the exception of one transaction not relevant here, Wendee's accounts were inactive until January 1976. In that month, Wendee received a distribution from a family trust and deposited it in her regular account at Smith Barney. The distribution consisted of 822 non-saleable voting certificate shares in Badger Meter Company, "blue-chip" securities with a market value of $97,814, and $8,000 in cash, which was immediately used to purchase another "blue-chip" stock. The value of Wendee's portfolio in January 1976, including some stock already in the account and not including the Badger Meter voting certificates, was $105,814. Wendee had an express agreement with George that her capital was to be preserved and ultimately used for the education and life needs of the couple's daughter.

In February 1976, George arranged to have the address on Wendee's accounts changed from the couple's home to Smith Barney. Thereafter, all monthly statements, confirmation slips and checks issued out of the account were received by George at his office. Smith Barney's Compliance Manual required that a client's change of address should be "carefully reviewed" and that a letter confirming the requested change of address should be mailed to the client at the old address. Although Smith Barney had no record of a written change of address request on the account, Milwaukee Branch Manager Richard Vermillion testified that it was his belief that George had filed such a written change of address request. No letter confirming the requested change was ever sent by Smith Barney to Wendee at her home address.

In October 1976, George and Wendee separated because of marital problems due apparently in part to George's involvement with a group of friends who engaged in gambling and heavy drinking. Although the couple initially hoped to reconcile, Wendee filed a divorce action in the spring of 1977. They were divorced in 1978.

Despite George's problems and their marital difficulties, Wendee left her investment arrangement unchanged because she

retained "100% faith" in George as her broker; because the account was supervised by other Smith Barney personnel, including Branch Manager Richard Vermillion, a personal friend of Wendee's parents; and because she believed that having her investments at Smith Barney was "like having money in a bank." Vermillion and his successor Leonard Walsh, testified that they were aware of George's marital problems and of his gambling activities.[4] Vermillion on several occasions in 1976 spoke with George about his gambling and told him to stop it. Vermillion also testified that he knew Wendee relied totally on George to manage her accounts. Both Vermillion and Walsh knew that Wendee was not receiving any written information on the accounts from Smith Barney after January 1976.

Starting in February 1976, after the change of address on the account and before their separation, George began to sell off Wendee's "blue-chip" securities. Between then and October 1977, George ordered 17 Smith Barney checks totalling $54,798.57, derived from the sales and payable to Wendee, to be drawn on Wendee's Smith Barney account but delivered to him. Another Smith Barney check for $558.40 was issued on January 20, 1976, before the address on the account was changed, bringing the total to $55,356.91. Wendee never knew of the sales transactions nor saw any of the checks, although a facsimile of her signature appeared on each of them. Checks totalling $43,825.57 were deposited in the couple's joint savings account and within a few days of each deposit an amount approximately equal to the deposit was withdrawn by George. The remaining converted $11,531.34 did not pass through the savings account. Wendee testified that she did not know that the joint savings account was still in existence.

Smith Barney's internal rules prohibit any stockbroker from receiving a check for delivery to a client unless the branch manager approves the delivery and makes a written record of

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[4] Wendee argues on appeal that the district court erred in excluding from evidence the fact that Leonard Walsh placed a bet or bets through George and George's bookie. In view of our disposition of the case, we find it unnecessary to discuss this alleged error.

the circumstances requiring delivery to the stockbroker. No such written records were produced at trial, but Vermillion and Walsh testified that between them they had approved all 17 checks delivered to George. Vermillion testified that George had told him that he was liquidating Wendee's securities because he did not like the market and that it was more convenient for him to receive the checks at the office as they were to be deposited in a bank in the same building as the Smith Barney office. Walsh testified that he never asked, and George never told him, why George was withdrawing the cash.

During the same period of time, George activated Wendee's option and margin accounts. Between July 1976 and February 1977, the outstanding loan balance in the margin account ranged from a high of $71,180 in August of 1976 to a low of $45,480 in October 1976, and in February 1977 stood at $60,280. In that month, George began purchasing calls, a form of option trading which the district court found was inconsistent with the option client approval sheet on Wendee's account and unsuitable in terms of Wendee's recorded investment objectives. How these transaction were approved by Smith Barney's branch manager and the New York compliance section will be discussed in detail in Part II. As a result of the call purchases, Wendee's account lost $33,564.31. The trading activity in the accounts also generated $21,754.65 in commissions and margin interest. Consequently, by the end of October 1977 nothing remained in Wendee's portfolio except the 822 nonsaleable shares of Badger Meter Company.

Throughout this time, George was furnishing Wendee with periodic account summaries fraudulently indicating an equity above $100,000. George also completed, in connection with the divorce proceedings in the spring of 1977, a financial declaration fraudulently stating the value of Wendee's securities to be $114,000. Wendee did not suspect that there might by anything wrong with her accounts until January 1978 when she learned that George had re-mortgaged their house. Leonard Walsh, the branch manager who had responsibility for supervising Wendee's account throughout 1977, did not learn that the ac-

counts had been depleted until March 1978 when this lawsuit was commenced.

Wendee's complaint stated eight claims and alternative claims based on provisions of the federal securities laws, state common law and the rules of the New York Stock Exchange and the National Securities Dealers Association. At the trial George invoked his Fifth Amendment rights and declined to answer any questions concerning his alleged wrongdoing.

The district court found that George had unlawfully converted to his personal use $55,356.91 of Wendee's account funds in violation of state common law, Section 10(b) of the Securities and Exchange Act of 1934 (15 U.S.C. §78j) and the Securities and Exchange Commission Rule 10b-5 (17 C.F.R. §240.10b-5). He also found that George's purchase of calls was a part of a scheme to offset and conceal his conversion and that taken as a whole George's activities constituted a scheme to defraud his client in violation of his fiduciary duty, Section 10(b) and Rule 10b-5. He therefore held George liable for the $33,564.31 loss resulting from the call purchases, thus far totalling a recovery of $88,921.22 for Wendee. Finally George was held liable for $21,754.65 for commissions and margin account interest. Those rulings are not challenged in this appeal.

Wendee also sought damages against Smith Barney alleging liability under the common law doctrine of *respondeat superior* and under Section 20(a) of the Securities and Exchange Act of 1934 (15 U.S.C. §78t(a)). The district court denied recovery of the $88,921.22 trading losses and monies converted under either theory but found Smith Barney jointly and severally liable with George for the $21,754.65 in commissions and margin expense (plus interest) on the reasoning that Smith Barney would be unjustly enriched if permitted to profit from George's misconduct. Wendee's appeal and Smith Barney's cross-appeal followed.

II

Section 20(a) of the Securities and Exchange Act of 1934 provides in pertinent part:

> "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

In *Fey v. Walston & Co., Inc.*, 493 F .2d 1036, 1051 (7th Cir. 1974), this Court held that a broker-dealer would be liable for its employee's acts under Section 20(a) if it "did not maintain a reasonably adequate system of internal supervision and control over the [registered representative] or did not enforce with any reasonable diligence such system***." Wendee's contention is that Smith Barney failed to enforce its internal compliance rules with reasonable diligence and is therefore liable under Section 20(a) for all the damages she suffered as a result of George's unlawful acts.

The district court found first that George's unlawful conversion of $55,356.91 of Wendee's account funds could not have been prevented by Smith Barney's reasonably diligent enforcement of its internal rules because Wendee would not have discovered the thefts even if the address on the account had been changed since by her own admission she did not concern herself with correspondence from Smith Barney and since the first converted check had in fact gone to the couple's home. The court also found that even if the change of address had facilitated George's misconduct, Smith Barney had not been guilty of an unreasonable lack of diligence with respect to the change of address or the approval of the cash withdrawals delivered to George because Rule 409(b)(2) of the New York

Stock Exchange expressly permits a registered representative to receive his wife's checks on accounts over which he holds a power of attorney and because Branch Managers Vermillion and Walsh received plausible explanations for both the change of address and the cash withdrawals. Finally, the district court found that Smith Barney was not guilty of unreasonable diligence in supervising the quality of trading in Wendee's accounts.

We think the record shows plainly that Smith Barney in fact did not properly follow its own compliance rules with respect either to the change of address request or to the checks delivered to George, but we nevertheless agree with the district court for the reasons it gave that the technical lack of compliance in these matters standing alone would not have constituted a violation of Section 20(a). We cannot agree, however, that Smith Barney was reasonably diligent in its supervision of the trading in Wendee's account, and we further conclude that this lack of reasonable diligence in combination with the generally casual supervision of George's activities contributed not only to the trading losses and commission and margin expenses but to the conversions as well.

As noted, each transaction in Wendee's account should have been approved by the Milwaukee branch manager prior to entry and reviewed by the compliance section in New York. However, of the 40 ticket orders produced by Smith Barney at trial for Wendee's accounts in 1976, four were approved by someone other than the branch manager and 13 were not approved by anyone. Moreover, as the district court found, call purchases were not authorized for Wendee's account. Although George Howard, a compliance officer in New York, testified to the effect that the account "must have" been approved for call purchases because otherwise the computer would have flagged the orders, no written record was produced to contradict the original option client approval sheet authorizing only covered writings. Vermillion, Walsh and Howard each conceded that call purchases were, as the district court found, unsuitable for an account with stated investment objectives of "long-term

growth" and "growth," but stated their belief that Wendee's recorded objectives were superseded when she executed the option and margin account agreements because a client who enters such an agreement automatically becomes a speculator. Smith Barney's Compliance Manual does not so provide, however, and Vermillion and Walsh admitted that there was no Smith Barney policy of communicating such a consequence to clients at the time they execute either an option or margin account agreement.

In addition, Smith Barney's internal rules, as noted, prohibit option trading for investors having less than $20,000 in investment assets and a $20,000 annual income. Wendee, whose annual income was less than $5,000 annually, was therefore not a qualified options investor. Her account was nevertheless approved for option trading on the strength of George's $30,000 annual income despite the facts that the compliance rules do not authorize consideration of a spouse's income on a single account, that George had his own option trading account, and that Vermillion, Walsh and Howard thought it unnecessary to review the activity in the two option accounts (supported by one salary) in conjunction with one another. An expert witness testified that a spouse's income is irrelevant to an investor's suitability for option trading under the "20-20" rule unless the account is jointly held.

Finally, Smith Barney requires, in addition to daily and monthly reviews for discretionary accounts, that any account generating five or more trades in one month be reviewed for excessive activity or "churning" by the compliance section, the branch manager and the broker on the account. After four months of reported excessive activity in a 12-month period, a comprehensive six-month review of profits, losses and commissions by the branch manager is required and a direct consultation with the client recommended. Excessive activity reports should have issued for Wendee's account in January, February and July 1976, but did not issue because, according to the testimony of Compliance Officer Howard, the computer in New York had not yet been fully programmed following Smith

Barney's merger with Harris, Upham & Co. in February 1976. New York did issue excessive activity reports for October and December 1976, but these reports were not reviewed as required by the Milwaukee office, apparently because of some disruption in procedure when Leonard Walsh replaced Richard Vermillion as branch manager.

Had excessive activity reports issued in accordance with Smith Barney procedure, a 6-month review would have been required on the account after the October 1976 report. As it turned out, it was not until the account was flagged by the computer for excessive activity (18 trades) in January 1977 that Compliance Officer Howard requested Leonard Walsh to obtain from George a review of Wendee's account. George did not complete the requested review until March 8, 1977, and his report misrepresented the equity in Wendee's account at $110,000. Walsh did not detect the misrepresentation because, according to his testimony, he was interested only in the profits and losses and not the equity figures.

When the account was flagged again in February 1977 (20 trades), Howard requested Walsh to obtain from Wendee, as the Compliance Manual required, a letter stating that the trading activity in her account was in accord with her investment objectives. Walsh told Howard that such a letter was unnecessary because he had just had dinner with Wendee, and Howard agreed to waive the need for written approval. Walsh testified, however, that in fact the dinner had been a social visit and that he had never discussed Wendee's account with her on that or any other occasion.

When the account was again flagged for excessive activity (24 trades) in May 1977, Walsh had an office worker prepare a six-month profit and loss analysis on the account. The resulting report was, by Walsh's admission, erroneously prepared and as a consequence showed $100,000 of equity, $14,926.29 in profits and $12,500 in commissions when it should have shown $55,916.85 of equity and a $294.57 loss for the period before commissions of $12,500. As a result of this sequence of omitted

and erroneous reports, Leonard Walsh had no idea what had happened to Wendee's account until this lawsuit was commenced.

The foregoing summary of the record clearly establishes a lack of reasonably diligent enforcement of internal supervisory rules. However, the district court reached the conclusion that Smith Barney was not liable under Section 20(a) on the ground that Smith Barney's supervisory personnel were entitled to rely on George's investment decisions because Wendee had given him broad discretionary power over the accounts. This view is based on a misunderstanding of the fiduciary relationship between George and Wendee. Wendee opened discretionary accounts at Smith Barney giving George, as her broker and as Smith Barney's representative, discretionary powers over her accounts. In short, Wendee's agent in the management of her accounts was Smith Barney as represented by their agent George Henricksen. By accepting Wendee's discretionary accounts, Smith Barney took upon itself a far more stringent fiduciary responsibility than it undertakes with respect to nondiscretionary accounts in which the client retains control over the management of his investments. See, *e.g.*, *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F.Supp. 203, 213 (D. Mass. 1978). Smith Barney recognizes this greater obligation in its compliance rules by requiring supervisory approval of discretionary transactions on a daily basis as well as monthly reviews. The fact that Wendee and George were husband and wife did not in any way relieve Smith Barney of its duty of supervision over Wendee's accounts. Indeed, if anything, it increased that duty because, as Smith Barney's internal rules also provide, employee-related accounts, whether discretionary or not, are subject to greater scrutiny than non-employee-related accounts. Smith Barney failed to follow its own compliance rules and procedures for supervising discretionary accounts, and it cannot now claim in defense that it relied on the discretionary judgment of the very person it was supposed to be supervising to justify the lack of supervision.

Had Wendee's account been properly supervised, it would have been subject to a full review in November 1976 following the fourth excessive activity month in a 12-month period. The computer programming delay and the turnover in personnel in the Milwaukee office do not excuse the absence of required supervision in this period. It cannot be known with certainty that George's conversion of withdrawals would have been deterred or detected and stopped by such a review. However, there can be no doubt that Smith Barney's failure to enforce its supervisory procedures violated Section 20(a) and that it contributed not only to George's unauthorized option trading but also to the ease with which he withdrew and converted the proceeds from the sale of Wendee's "blue-chip" stocks. Consequently, we hold that Smith Barney is liable to Wendee under Section 20(a) for the $33,564.31 lost through the unauthorized purchase of calls, the $21,754.65 in commissions and margin expenses, and the monies lost through conversion between November 1976, when the first full review of her Smith Barney account should have been conducted, and the end of October 1977 when that account reached zero, plus prejudgment interest and costs.

III

Wendee also charged Smith Barney with liability for the unlawful acts of its agent, George, under the common law doctrine of *respondeat superior*. This claim is independent of, and the potential liability broader than, that under Section 20(a). See *Fey v. Walston, supra,* 493 F.2d at 1052-1053; see also *Marbury Management, Inc. v. Kohn,* 630 F.2d 704 (2d Cir. 1980); *Paul F. Newton & Co. v. Texas Commerce Bank,* ... F.2d ..., 49 LW 2392 (5th Cir. November 21, 1980). As we stated in *Fey, supra,* 493 F.2d at 1052 n. 19:

> "[U]nder common law principles, a principal is liable for the deceit of its agent committed in the very business he was appointed to carry out. This is true even though the latter's specific conduct was carried on without knowledge of the principal."

The district court acknowledged that "normally" Smith Barney would be liable for all the damages resulting from George's fraudulent acts, but held that Wendee's claim was barred here because George was acting as her agent as well as Smith Barney's agent and Wendee was in a better position than Smith Barney to detect and prevent George's fraud. The court then went on to hold that Smith Barney was nevertheless liable for the $21,754.65 in commissions and margin expenses because, notwithstanding Wendee's greater ability to prevent the wrong, Smith Barney should not be permitted to profit as a result of wrongs committed by its agent.

These findings also turn on the erroneous understanding discussed above, of the fiduciary relationships among George, Wendee and Smith Barney. Wendee's opening of discretionary accounts at Smith Barney did not create a classic "dual agency" situation. George was not acting nor was he authorized to act as Wendee's agent independent of his position as a stockbroker employed by Smith Barney. As we have already stated, the primary agency relationship created by the discretionary accounts was between Wendee and Smith Barney, with George acting on Smith Barney's behalf.

Having entrusted her investments to Smith Barney's management through George, their agent, Wendee was entitled to rely on Smith Barney's fiduciary obligation to manage the investments in accordance with her recorded investment objectives and George's best professional judgment subject to the review and ultimate control of Smith Barney's supervisory personnel. It is true, of course, as Smith Barney argues, that had Wendee not authorized discretionary accounts or had she herself supervised George's investment decisions, she might have discovered and prevented the fraud. But Wendee has no obligation to supervise George. She received periodic reports from George indicating an equity in her account of over $100,000 and at the time of the divorce action in the spring of 1977 was provided with a financial declaration stating the equity to be $114,000. She was entitled to rely on George's representations of the status of her account and to assume therefrom that

the account was being properly managed by George and Smith Barney. Indeed, the whole point of a client's establishing a discretionary account is to turn over to the investment firm management and investment responsibilities that the client either does not want to have or feels inadequate to handle.

Broker-dealers do not have to accept discretionary accounts. Harris, Upham & Co., for example, had a policy against accepting such accounts before its merger with Smith Barney. But having accepted Wendee's trust and the concomitant fiduciary burdens, Smith Barney cannot now disclaim liability by arguing that Wendee should not have been so trusting. Accordingly, we hold that Smith Barney is liable to Wendee jointly and severally with its agent George Henricksen under state common law not only for the damages discussed above for which Smith Barney is independently liable under Section 20(a) but in addition for the monies converted by George in the course of his management of the fund prior to November 1976 and Smith Barney's violation of Section 20(a).

For the reasons stated, the judgment of the district court is reversed to the extent that it denied plaintiff recovery from Smith Barney for the sum of $88,921.22, plus prejudgment interest on that sum computed at the rate of 5% per annum since November 1, 1977, plus costs, and in all other respects is affirmed. Costs on appeal are taxable to Smith Barney.

A true copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

Opinion by Judge Cummings
JUDGMENT — ORAL ARGUMENT
UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

February 6, 1981

Before
Hon. WALTER J. CUMMINGS, Circuit Judge
Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. WILLIAM J. CAMPBELL, Senior District Judge*

WENDEE HENRICKSEN,
Plaintiff-Appellant,
No. 80-1488 Vs.

GEORGE HENRICKSEN, and
SMITH, BARNEY, HARRIS,
UPHAM & CO, INC.,
Defendants-Appellees.

Appeals from the United States District Court for the Eastern District of Wisconsin

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WENDEE HENRICKSEN,
Plaintiff-Appellee,
No. 80-1584 Vs.

SMITH, BARNEY, HARRIS,
UPHAM & CO, INC.,
Defendant-Appellant.

No. 78-C-208
Judge Myron L. Gordon

This cause was heard on the record from the United States District Court for the Eastern District of Wisconsin, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, REVERSED to the extent that it denied plaintiff recovery from

Smith Barney for the sum of $88,921.22, plus prejudgment interest on that sum computed at the rate of 5% per annum since November 1, 1977, plus costs, and in all other respects is AFFIRMED. Costs on appeal are taxable to Smith Barney in accordance with the opinion of this Court filed this date.

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* The Honorable William J. Campbell, Senior District Judge of the Northern District of Illinois, is sitting by designation.

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

A True Copy:
Teste:

March 30, 1981

Before
Hon. WALTER J. CUMMINGS, Circuit Judge
Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. WILLIAM J. CAMPBELL, Senior District Judge*

WENDEE HENRICKSEN,
Plaintiff-Appellant,
Cross Appellee,
Nos. 80-1488 & 80-1584 vs.
GEORGE HENRICKSEN and
and SMITH BARNEY,
HARRIS UPHAM & CO., INC.,
Defendants-Appellees.
Cross Appellant.

Appeal from the United States District Court for the Eastern District of Wisconsin
No. 78-C-208
Myron L. Gordon, Judge.

ORDER

On consideration of the petition for rehearing and suggestion for rehearing *en banc* filed in the above-entitled cause by defendant-appellee and cross-appellant Smith Barney, Harris Upham & Co., Inc., no judge in active service has requested a vote thereon, and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

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* The Honorable William J. Campbell, Senior District Judge of the Northern District of Illinois, is sitting by designation.

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF WISCONSIN

WENDEE HENRICKSEN,

Plaintiff,

v. No. 78-C-208

GEORGE HENRICKSEN and
SMITH, BARNEY, HARRIS,
UPHAM & CO., INC.,

Defendants.

DECISION and ORDER

The plaintiff Wendee Henricksen seeks to recover in this action the approximate sum of one hundred and twenty thousand dollars from her former husband, George Henricksen, and his former employer, Smith, Barney, Harris Upham & Co., Inc. (Smith Barney). The complaint states eight claims and alternative claims for relief, based on provisions of the federal securities laws, state common law, and certain rules of the New York Stock Exchange and the National Association of Securities Dealers. A two day bench trial was held in early January 1980, and the parties have submitted post-trial briefs. This opinion constitutes the court's findings of fact and conclusions of law pursuant to Rule 52, Federal Rules of Civil Procedure.

I. BACKGROUND

The plaintiff and George Henricksen were married in August 1969. In January 1970, Mrs. Henricksen received a bachelor of arts degree. The Henricksens moved to New York where George Henricksen underwent a six month training program with Smith Barney to become a stockbroker. The Henricksens then moved to Milwaukee, and Mr. Henricksen worked for Smith Barney as a registered representative from 1970 through 1977, the time period covering the events pertinent to this case.

On June 19, 1972, the plaintiff opened a customer account at Smith Barney. The mailing address listed on the permanent account record was the Henricksen's home address. At that time, Mrs. Henricksen's investment objectives were recorded on Smith Barney's new account form. This document sets forth five possible investment objectives, ranging in five steps from "conservation of capital with stable income," the most conservative investment plan, to "speculative capital gains," the most speculative investment plan. The investment objective indicated for the plaintiff's account was step two, "long-term growth of capital - income secondary." The account was opened as a discretionary account, which meant that the plaintiff gave George Henricksen a power of attorney over the account. This power of attorney was formally evidenced by a written memorandum signed by the plaintiff, dated August 23, 1972.

The first transaction occurred in the account in June 1974, when Mrs. Henricksen deposited 17 shares of duPont stock. These shares were sold in June 1975, and 100 shares of J. D. Searle were purchased with the proceeds.

On July 2, 1975, Mrs. Henricksen signed a customer's option agreement which, she testified, she did not read before signing. The agreement states that the person signing it has "been furnished with the current Prospectus of The Options Clearing Corporation," and has "read it and particularly noted those buy and sell sections pertaining to Risk Factors, Suitabili-

ty and Limitations on Position and Exercise,..." The plaintiff testified that she was not furnished a copy of the prospectus before signing the option agreement and that she would not have understood it had it been furnished. The option agreement further states that the plaintiff agreed:

> "1. To make transactions in Options and other securities only in such manner as is consistent with my investment and/or trading objectives and with my overall and then existing financial circumstances."

The instrument also stated:

> "14. I have read and fully understand the terms and conditions of this agreement. I believe that I am capable of evaluating, carrying and bearing the financial risks inherent in all options trading."

At this time, two Smith Barney records were prepared and maintained with regard to the plaintiff's option account: an option client information sheet and an option client approval sheet. The information sheet stated that the account was a single, not a joint, account, that the plaintiff's estimated net worth was between $100,000 and $250,000, that her annual income was $5,000 and her husband's was $30,000, and that her assets totaled $123,000. Her investment objectives were stated to be "growth," rather than "income" or "speculation." The possible types of anticipated option transactions were listed as:

"a. Unsolicited transactions only
b. Purchasing Calls
c. Covered Writing
d. Spreading
e. Uncovered Writing
f. Discretionary Transactions."

The only type of transaction checked for the plaintiff's option account was "covered writing." The option client information sheet was signed by George Henricksen.

The option client approval sheet indicated that the account was a discretionary account and that the client's husband held a power of attorney over the account. This record then reflects, opposite the same categories listed on the information sheet, that the plaintiff's account was "Approved for Covered Writing Transactions Only." This document was signed by the branch manager of Smith Barney's Milwaukee office, Smith Barney's registered options principal, and by a member of its compliance review section.

Richard Vermillion, the Milwaukee branch manager from June 1975 through October 1976, testified that copies of both of these Smith Barney records were on file in his office, but Leonard Walsh, Mr. Vermillion's successor, testified that he was unaware of the existence of these records. George Howard, a member of Smith Barney's compliance section, testified that a copy of the client option approval sheet for the plaintiff's account is still on file in his office. Mr. Howard also testified that sometime between April and October, 1976, a "yellow card" was sent to every registered representative for him to designate his option clients' investment objectives and that the plaintiff's account was thereafter programmed into Smith Barney's new computer system as approved for call purchasing transactions. However, Mr. Howard stated that the yellow card for the plaintiff's account could not be located, and no such card was ever produced at trial.

On November 3, 1975, Mrs. Henricksen executed another document giving her husband a power of attorney over her account at Smith Barney. This document, which the plaintiff testified she did not read before signing, provides:

> "That I, Wendee Henricksen of 8334 North Links Way, City of Milwaukee, State of Wisconsin, have made, constituted and appointed, and by these presents do constitute and appoint George B. Henricksen my true and lawful attorney for me and in my name, place and stead, to manage, handle and direct all accounts now standing in my name, or which may at any

time be opened by me or in my name, with Smith, Barney & Co. Incorporated, to buy and sell bonds, stocks and other securities in my name; for me in my name to make execute and deliver assignments and transfers of any and all stocks and bonds, and to that end to sign my name to any and all written instruments which may be required in connection with such transfer or hypothecation.

"This power of attorney shall apply to and cover all accounts which I may have with Smith, Barney & Co. Incorporated, until written notice of revocation hereof is given by me to said Corporation, and I hereby ratify and confirm any and all acts which may hereafter be done or caused to be done by virtue hereof by my said attorney giving and granting unto my said attorney full power and authority to do and perform all and every act and thing whatsoever requisite and necessary to be done in and about the premises as fully to all intents and purposes as I might or could do if personally present."

On January 20, 1976, Mrs. Henricksen signed a margin contract with Smith Barney. This agreement provided that, in connection with any indebtedness incurred as a result of transactions in the plaintiff's account, Smith Barney "may charge monthly, as interest or otherwise, such sums to compensate [Smith Barney] for advances made on my account as [Smith Barney] may determine to be reasonable in view of the current cost of money." Although the plaintiff also did not read this document before she signed it, she testified that she had Mr. Henricksen explain it to her.

Also in January 1976, the plaintiff deposited into her Smith Barney account six so-called "blue-chip stocks," $8,000 in cash, and 822 shares of Badger Meter stock in the form of non-saleable voting trust certificates, all of which she had received from a trust. As of January 26, 1976, the plaintiff's Smith Barney account, including the 100 shares of G. D. Searle stock

and excluding the 822 shares of Badger Meter stock, had a fair market value of $105,814. After the cash was used on January 28th to purchase stock in Kennecott Copper Corporation, the plaintiff's account, at the end of January 1976, consisted of the eight "blue-chip" stocks and the non-saleable Badger Meter certificates. The plaintiff testified that she and her husband had an express understanding that these stocks and the capital they represented were to be conserved and ultimately dedicated to the education and other needs of the couple's daughter, Heather.

In February 1976, George Henricksen arranged to have the address on the plaintiff's account changed from the couple's home to the Smith Barney office. Henceforth, the monthly statements, confirmation slips, and any checks issued out of the account were received by Mr. Henricksen at his office. With regard to changes of address, Smith Barney's compliance manual provides:

> "Customer requests for change of address should be carefully reviewed and a letter sent to customer's old address acknowledging receipt of customer's request to change the address to a new address."

Although Smith Barney was unable to produce at trial either a written request for a change of address from the plaintiff or a letter from Smith Barney to the plaintiff acknowledging the address change, Richard Vermillion testified that he believed George Henricksen had submitted a written request. He further testified that Mr. Henricksen, either then or later, explained that the change of address made it more convenient for him to deposit checks issued from the plaintiff's Smith Barney account into the couple's joint savings account, because the savings account was maintained with a bank that had an office in the same building as the Smith Barney office, and that the savings account deposits were made in order to shelter a portion of his wife's assets during bad market conditions. Leonard Walsh testified that George Henricksen informed him that the address change allowed him to keep all of the records of the account at

his office, simplifying the preparation of the plaintiff's income tax returns.

By the end of October 1977, the only securities in the plaintiff's Smith Barney account were the 822 shares of non-saleable Badger Meter stock; between January 1976 and November 1977, not counting these 822 shares, the equity in the account was reduced to zero. During this period, George Henricksen caused seventeen checks totaling $54,798.51 to be drawn on the account in the plaintiff's name but delivered to him at his office. Another check for $558.40 was issued on January 20, 1976, when the address of the account was still listed as the couple's home address. The plaintiff did not personally endorse the checks, but an endorsement nevertheless was placed on the checks; drafts totaling $43,825.57 were deposited into the couple's joint savings account. Within days of each deposit, however, an amount equal or approximately equal to the amount deposited was withdrawn from the savings account. Also during this period the account lost $33,564.31 in the purchase of calls, a form of options trading. Finally, a total of $17,872.24 was paid to Smith Barney in commissions over the same period, as was $3,882.41 in interest charges on margin transactions. Thus, between January 1976 and November 1977, the account was drained of a total of $110,675.87 in cash withdrawals, trading losses, commissions and interest.

The plaintiff presented evidence at trial showing that Smith Barney's local managers knew that during 1976 and 1977 George Henricksen had engaged in gambling and heavy drinking. Richard Vermillion testified that he knew that Mr. Henricksen had been to Las Vegas several times during 1976 and had reportedly won over $10,000 on one such visit. Mr. Vermillion further testified that he was concerned about George Henricksen's personal life and that he counseled Mr. Henricksen on numerous occasions in an effort to persuade Mr. Henricksen to stop gambling. Leonard Walsh also testified that he was aware of George Henricksen's gambling.

In October 1976, the plaintiff and George Henricksen separated; Mr. Henricksen moved out of the couple's home. Mr. Vermillion and Mr. Walsh were aware of the separation, but both testified that they believed a reconciliation was possible. In the spring of 1977, however, the plaintiff filed for a divorce, which subsequently became final.

Not until January 1978 did the plaintiff discover that only the 822 shares of Badger Meter stock remained in her Smith Barney account. Since the change of the account's address, the plaintiff had not been receiving any statements regarding her account. Her husband periodically provided her with summaries of her account, but these summaries showed the account as having an equity in excess of $100,000. Similarly, in an undated financial declaration completed in connection with the divorce proceeding commenced in the spring of 1977, George Henricksen listed the value of the plaintiff's securities as $114,000. On each of these occasions, the equity in the account was considerably lower than the amount George Henricksen stated.

Mrs. Henricksen testified that she knew nothing about the cash withdrawals and never received the proceeds of the cashed checks. Leonard Walsh had dinner with the plaintiff and George Henricksen in February 1977, but the account was not mentioned. What evidently caused the plaintiff to inquire about her Smith Barney account was her discovery in January 1978 that George Henricksen had refinanced the mortgage on the home where only the plaintiff was then living. The plaintiff commenced this action on April 3, 1978.

II. LIABILITY OF GEORGE HENRICKSEN

For purposes of clarity, I will analyze the potential liability of each defendant within the four categories of losses sustained by the plaintiff: cash withdrawals, trading losses, commissions and interest. There is substantial evidence in the record to warrant the inference that George Henricksen converted to his per-

sonal use the large amount of cash ($55,356.91) withdrawn from the plaintiff's account during the period in question. Smith Barney's records indicate that this amount was withdrawn from the account during 1976 and 1977. (Exhibit 13). The plaintiff testified that she was totally unaware that this cash had been taken from her account. Of the eighteen checks which were issued, the last seventeen were delivered directly to Mr. Henricksen at his office. The first check was apparently delivered to the couple's home address, but the plaintiff testified that even before the change of the account's mailing address, her husband handled all mail received from Smith Barney. Although the plaintiff testified that she never saw any of the checks, each of the seventeen checks delivered to George Henricksen bears a likeness of her signature. Finally, Richard Vermillion testified that Mr. Henricksen told him that the checks were being deposited into the couple's joint savings account; however, the records of the savings account indicate that only $43,825.57 reached the account, leaving $11,531.34 totally unaccounted for.

At trial, when questioned about the large cash withdrawals and the fate of the checks, George Henricksen invoked the fifth amendment privilege against self-incrimination; indeed, he responded in this fashion to all questions. It is now clearly established "that the Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them...." Baxter v. Palmigiano, 425 U.S. 308, 318 (1976). The Wisconsin supreme court has articulated the following reasons for permitting the drawing of such an inference:

> "This court in *Grognet v. Fox Valley Trucking Service* (1969), 45 Wis.2d 235, 172 N.W.2d 812, stated it had long been recognized in Wisconsin that a person may invoke the fifth amendment in a civil case in order to protect himself from the use of such evidence against him in a subsequent criminal action; but if he did so, an inference against his interest might be drawn. Since the inference is irresistible and logical in such cir-

> cumstances, the court may as a matter of law draw the inference. Such an inference is based upon an implied admission that a truthful answer would tend to prove that the witness had committed the criminal act or might constitute a criminal act.... The administration of justice and the search for truth demands that an inference may be drawn that a witness' testimony would be unfavorable to him in a civil action in which the privilege is invoked to protect himself from a subsequent criminal action." Molloy v. Molloy, 46 Wis.2d 682, 687-88 (1970).

These cases are to be distingished from the line of cases in which the United States Supreme Court disapproved of state attempts "to compel testimony that had not been immunized" by threatening to impose immediate sanctions upon persons refusing to waive their fifth amendment privilege. Lefkowitz v. Turley, 414 U.S. 70, 82 (1973). *See also* Lefkowitz v. Cunningham, 431 U.S. 801, 808 n.5 (1977); Sanitation Men v. Sanitation Comm'r, 392 U.S. 280 (1968); Gardner v. Broderick, 392 U.S. 273 (1968); Garrity v. New Jersey, 385 U.S. 493 (1967).

Of course, as I suggested during the trial, Mr. Henricksen's silence should be "given no more evidentiary value than [is] warranted by the facts currounding [t]his case." Baxter v. Palmigiano, *supra*, 425 U.S. at 318. Even according only slight weight to George Henricksen's invocation of the privilege, in light of the testimony summarized above and under all the circumstances of this case, his silence in the face of probative evidence admitted against him supports my conclusion that he did in fact, for his own purposes, dispose of the cash withdrawn from the plaintiff's account. Since the power of attorney the plaintiff gave George Henricksen in 1975 did not authorize the latter "to dispose of the assets for his own purposes," and "[i]nasmuch as the agent herein has failed to account for his principal's funds, he is liable for conversion." Alexopoulos v. Dakouras, 48 Wis.2d 32, 41 (1971).

This conversion of the plaintiff's funds, which was accomplished pursuant to a scheme to defraud the plaintiff "in connection with the purchase or sale" of securities, also constitutes a violation of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j, and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5. *See* 1 A. Bromberg, Securities Law: Fraud § 5.4, at 99 & n.33 (citing cases). For this illegality the defendant George Henricksen is liable to the plaintiff in the amount of $55,356.91.

George Henricksen is also liable to the plaintiff for the losses the account sustained as a result of his purchases of calls. The evidence clearly shows that these transactions were inconsistent with the plaintiff's investment objectives and that George Henricksen knew this to be true. When the plaintiff opened her Smith Barney account, her investment objective was listed as "long term growth of capital - income secondary." Although the plaintiff did execute an option agreement with Smith Barney, both the option client information sheet and the option client approval sheet indicate that the only type of option transaction authorized for the plaintiff's account was "covered writing;" "purchasing calls" was not checked on either form. Moreover, the plaintiff testified that she and her husband understood that the funds in her Smith Barney account were to be conserved for the benefit of their daughter; George Henricksen knew that this goal was seriously jeopardized by his speculative trading in call options.

The 1975 power of attorney does not exonerate Mr. Henricksen from liability for these trading losses. Rather, by virtue of the execution of that document, and as an incident of the broker-customer relationship, George Henricksen owed a fiduciary duty to the plaintiff. *See* Schweiger v. Loewi & Co., Inc., 65 Wis.2d 56, 65 (1974). As a fiduciary, Mr. Henricksen was duty-bound to disclose all facts relevant to the terms of the agency, which he failed to do, and to act strictly in accordance with his principal's wishes and interests. His purchases of calls were adverse to the plaintiff's clearly-expressed interests and therefore constitute a breach of his fiduciary duty. *See* Bank of

California v. Hoffman, 255 Wis. 165, 171-171a (1949); Faultersack v. Clintonville Sales Corp., 253 Wis. 432, 437 (1948).

I need not decide whether, assuming George Henricksen's investments in unsuitable securities violated Rule 405 of the New York Stock Exchange and Article III, § 2, of the rules of the National Association of Securities Dealers, this constitutes a violation of the anti-fraud provisions of the federal securities laws. I find that, independent of those rules, Mr. Henricksen's purchases of calls were part of a scheme to defraud the plaintiff within the meaning of 15 U.S.C. § 78j and Rule 10b-5. George Henricksen's speculative trading in calls coincided with his large, unauthorized cash withdrawals from the plaintiff's account. I believe that these risky but potentially very profitable transactions were undertaken in order to offset and to conceal the sizeable cash withdrawals. Thus, Mr. Henricksen's fraudulent scheme to conceal his unlawful conversion of the plaintiff's assets embraced a series of unsuitable investments in call options; for the losses resulting from this undisclosed, reckless course of conduct, George Henricksen is liable to the plaintiff in the amount of $33,564.31. *See* Wright v. Heizer Corp., 560 F.2d 236, 251-52 (7th Cir. 1977).

Turning now to the commissions the plaintiff paid on transactions in her account during 1976 and 1977, I believe these commissions were incurred as a proximate result of George Henricksen's fraudulent acts. In order to withdraw cash from the plaintiff's account, Mr. Henricksen first had to sell securities; these sales produced commissions which were charged to the account. George Henricksen's unsuitable investments in call options also generated a substantial volume of commissions.

I do not think it would be useful or helpful for me to attempt to apply the "churning" label to Mr. Henricksen's excessive trading in calls during the latter part of 1976 and the first half of 1977. That term is normally applied to excessive trading undertaken by a broker for the sole improper purpose of generating commissions, regardless of and contrary to the

customer's interests. In such a case, the broker's wrongful purpose of lining his own pockets is the cause of his customer's damages. *See* Fey v. Walston & Co., Inc., 493 F.2d 1036, 1040 n. 1 (7th Cir. 1974); Van Alen v. Dominick & Dominick, Inc., 441 F. Supp. 389, 400 (S.D. N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

In this case, however, the purpose behind George Henricksen's excessive trading in calls was not to generate commissions, as the record shows that commissions on his wife's account represented only 7.8% of his total commissions, but rather his purpose was to conceal his unauthorized cash withdrawals by reaping potentially large profits on risky investments. Thus, whether the technical churning formula does or does not fit the facts of this case, it is clear that the commissions charged on George Henricksen's purchases of calls were proximately caused by his scheme to conceal his simultaneous defalcations. Under both the common law of fiduciary duty and the federal securities laws, he is liable to the plaintiff for the commissions charged. *See* Fey v. Walston & Co., Inc., *supra*, 493 F.2d at 1054-55.

I believe the amount of commissions for which Mr. Henricksen is liable is the total sum charged during 1976 and 1977; it is over this period that his fraudulant scheme was perpetrated. Although some of the transactions in the plaintiff's account during this period arguably were not unsuitable or were otherwise unrelated to Mr. Henricksen's fraudulent acts,

> "[i]t is now elementary that when precise damage measurements are precluded by wrongful acts, the wrongdoer cannot insist upon exact measurements and the precise tracing of causal lines to an impractical extent; fair approximations are in order." Fey v. Walston & Co., Inc., *supra*, 493 F.2d at 1055.

In this case it would be impossible to sort the lawful from the unlawful transactions because the classification depends upon Mr. Henricksen's state of mind when any particular transaction

was initiated. Therefore, I hold that George Henricksen is liable to the plaintiff in the amount of $17,872.24, the total commissions charged during 1976 and 1977.

In my opinion, these principles also apply to the interest charged against the plaintiff's account. If George Henricksen had not been withdrawing cash from the account, purchases on margin would not have been necessary. While it is conceivable that some of the loans were contemplated by the plaintiff, particularly since she did in fact sign a margin contract after her husband explained it to her, fair approximations of damages are again appropriate here, because the same impossible task of classifying lawful and unlawful margin transactions would have to be performed. Accordingly, George Henricksen is also liable to the plaintiff for $3,882.41.

In addition to the damages the plaintiff may recover from George Henricksen in this case, I believe the plaintiff is entitled to recover prejudgment interest. "[T]he general rule [is that] prejudgment interest is available as a matter of law on a claim which is liquidable, or fixed and determinate." Murray v. Holiday Rambler, Inc., 83 Wis.2d 406, 439 (1978). The court of appeals for the seventh circuit, has held that the amount upon which prejudgment interest is to be computed must be ascertainable with reasonable certainty. Fattore Co. v. Metropolitan Sewerage Comm'n, 505 F.2d 1, 7 (7th Cir. 1974).

The legal rate of interest in Wisconsin is five percent. § 138.04, Wis. Stats. The period for computing such interest should commence on November 1, 1977. In my opinion, recovery of this combined sum--damages plus prejudgment interest--will fairly compensate the plaintiff for the financial loss caused by her ex-husband. Moreover, this sum closely approximates the fair market value her account would have had at the time of trial had it still contained the securities held in January 1976. *See* Fey v. Walston & Co., Inc., *supra*, 493 F.2d at 1054-55 n.26.

III. LIABILITY OF SMITH BARNEY

The plaintiff has advanced two theories for holding Smith Barney liable for her entire losses in this case: (1) derivative liability based on the common law principle of respondeat superior; and (2) derivative liability based on section 20(a) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78t(a). In addition, the plaintiff contends that Smith Barney is liable for the losses the account sustained as a result of George Henricksen's unsuitable investments in call options based on a violation of the "know your customer" rule of the New York Stock Exchange and the National Association of Securities Dealers.

An investor may recover from a broker for damages caused by the fraudulent acts of the broker's registered representative under the principle of respondeat superior. Fey v. Walston & Co., Inc., *supra,* 493 F.2d at 1052-53. Here, George Henricksen defrauded the plaintiff, and, normally, as George Henricksen's employer, Smith Barney would be liable for any damages caused by the fraud. *Id.* However, George Henricksen was not only Smith Barney's agent, but, by virtue of the 1972 and 1975 powers of attorney, he was also the plaintiff's agent. This dual agency relation complicates the outcome, for, under the following authorities, George Henricksen's fraud may just as easily be imputed to the plaintiff as it may be imputed to Smith Barney.

Although Mr. Henricksen's fraudulent acts were not within the authority granted by the powers of attorney and were adverse to the plaintiff's interests, as against third parties, section 161 of the Restatement (Second) of Agency asserts that a principal may be liable for even the unauthorized acts of its general agent. Moreover, it has long been the rule in Wisconsin "that he who has, although innocently, enabled any person to do an act which might be injurious to himself or to another innocent party, shall himself suffer the injury, rather than the innocent party who has placed confidence in him." Kasson v. Noltner, 43 Wis. 646, 650-51 (1878). *Accord,* Bronson's Executor v. Chappell, 79 U.S. (12 Wall.) 681, 683 (1870); Hollingsworth v. American Finance Corp., 86 Wis.2d 172, 181

(1979); Motor Castings Co. v. Milwaukee County Bank, 254 Wis. 493, 499 (1949); Voell v. Klein, 184 Wis. 620, 622 (1924). Since an agency relation connects both the plaintiff and Smith Barney to George Henricksen's fraud, the general rule that a principal is charged with his agent's fraudulent acts operates as a double-edged sword in this case, and the problem cannot be resolved by simple resort to it.

In my opinion, two other venerable common law principles furnish needed guidance for resolving the issue of Smith Barney's liability under the general law. The first of these is that, as between two parties who are otherwise similarly situated, the one who was in a better position to prevent the wrong should suffer any resultant loss. *See generally* Posner, 2 J. of Legal Studies 399 (1973). The second principle is that, notwithstanding one party's greater relative capacity to prevent the wrong, neither party should profit at the other's expense as a result of wrongs committed by a third person. Applying these principles to the facts of this case, I hold that the common law liability of Smith Barney extends to the commissions and interest charged to the plaintiff's account but not to the losses attributable to George Henricksen's unauthorized withdrawals and unsuitable investments in call options.

With regard to Mr. Henricksen's option purchases, Smith Barney was certainly entitled to believe that the plaintiff's husband was merely translating the plaintiff's wishes. Not only had she executed a power of attorney granting her husband broad discretionary authority over her account and expressly ratifying all acts he might perform as her attorney-in-fact, but she also had signed an option agreement which stated that she understood and accepted the inherent risks attending all option transactions. With regard to George Henricksen's conversion of the plaintiff's assets, it appears that the first check Mr. Henricksen converted was delivered to the couple's home address; Smith Barney cannot be liable for the amount of this check in any circumstances. As to the other seventeen checks, the testimony showed that Smith Barney's local managers questioned George Henricksen about the reasons behind both the change of ad-

dress on the account and his cash withdrawals. However, there is no evidence that the plaintiff ever asked her husband why, beginning in February 1976, she was no longer receiving any records on her account; in fact, the plaintiff testified that she never bothered with the records Smith Barney sent her every month before that date.

The plaintiff places great emphasis on the fact that Smith Barney's local managers knew during 1976 and 1977 that George Henricksen was involved in drinking and gambling and was experiencing serious marital problems. However, these negative factors of her husband's personal life must also have been known to the plaintiff. Yet, even after the couple separated in October 1976, and after the plaintiff filed for divorce in the spring of 1977, she failed to take any steps either to revoke the power of attorney or to have the records of her account mailed to her directly.

I am mindful that in accomplishing his fraudulent scheme George Henricksen utilized Smith Barney's facilities. However, courts should allocate liability in ways which encourage persons to be as resonsible for their own affairs as the situation permits and requires. In the circumstances of this case, I find that the plaintiff could easily have prevented or at least quickly detected her husband's fraud by taking reasonable precautionary steps which the facts known to her required. Accordingly, I believe it would be unfair to hold Smith Barney responsible for losses which stemmed in part from the plaintiff's total failure to be concerned about her own financial affairs.

On the other hand, I believe it would be equally unfair to permit Smith Barney to retain any benefits it received as a result of George Henricksen's fraudulent course of conduct. Courts have long been alert to force principals to disgorge the fruits of their agents' wrongful acts. *See generally* Stockwell v. United States. 80 U.S. (13 Wall.) 531, 548 (1871); Amen v. Black, 234 F.2d 12, 20-21 (10 Cir. 1956) (en banc); Estes v. Crosby, 171 Wis. 73, 79 (1920). This type of recovery "is not aimed at compensating the plaintiff, but at forcing the defendant to disgorge

benefits that it would be unjust for him to keep." D. Dobbs, Remedies § 41, at 224 (1973). Though Smith Barney may protest that it innocently acquired the benefits it received in this case and should therefore be permitted to retain them, even apart from the agency relationship between it and George Henricksen, the rule is that "restitution is generally awarded when the defendant has gained a benefit that it would be unjust for him to keep, though he gained it honestly." *Id.*

As I have previously discussed, the commissions and interest which were charged against the plaintiff's account must be treated as incidents of George Henricken's fraudulent behavior. In perpetrating the fraud, Mr. Henricksen utilized both his position with Smith Barney and the latter's facilities and instrumentalities. While the general law does not oblige Smith Barney to compensate the plaintiff for her losses, I hold that it does require Smith Barney to return to her the commissions and interest Smith Barney received as a result of George Henricksen's unlawful conduct.

The plaintiff is also entitled to recover prejudgment interest from Smith Barney, because the latter benefited from the *use* of the sums it received. The defendants will be jointly and severally liable for the sum of the commissions, interest, and prejudgment interest, but, since George Henricksen acted as Smith Barney's agent and was the wrongdoer, Smith Barney is entitled to indemnity from him for any amount it pays to the plaintiff. *See* Culver v. Webb, 244 Wis. 478, 491 (1944). *Cf.* Heizer Corp. v. Ross, 601 F.2d 330 (7th Cir. 1979) (indemnity not allowed where all defendants are wrongdoers).

Application of these general principles does not dispose of Smith Barney's potential liability under the federal securities laws. The relevant statute, 15 U.S.C. § 78t(a), provides that:

> "Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as

> such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

The court of appeals for this circuit has interpreted this provision to mean that persons in control shall be liable if they "did not maintain a reasonably adequate system of internal supervision and control...or did not enforce with any reasonable diligence such system...." Fey v. Walston & Co., Inc., *supra*, 493 F.2d at 1051. The question is whether Smith Barney is liable under this statute for the plaintiff's losses due to George Henricksen's unauthorized cash withdrawals and option transactions.

Upon careful consideration of all the relevant facts, I am satisfied that George Henricksen's unlawful conversion of the plaintiff's funds was not due to any failure on Smith Barney's part to enforce with reasonable diligence its internal plan of supervision. Though the plaintiff contends that the change of address on the account enabled George Henricksen to convert her assets, the record shows that the first check Mr. Henricksen converted was delivered to the couple's home address. In fact, according to the plaintiff's own testimony, she would not have discovered the continuing thefts even if the address on the account had not been changed because she did not concern herself with mail from Smith Barney but left such matters to her husband.

Assuming the change of address did facilitate George Henricksen's defalcations, I believe Smith Barney was not guilty of an unreasonable lack of diligence. Rather, both its local managers questioned Mr. Henricksen about the change of address and received plausible explanations as to the reasons behind both the change of address and the cash withdrawals. Moroever, rule 409(b)(2) of the New York Stock Exchange expressly permits a registered representative to receive his wife's mail over those account he holds a power of attorney. It should

be remembered that the checks themselves were made out to Wendee Henricksen, and only by placing her endorsement onto the checks was George Henricksen able to cash them; certainly Smith Barney had no more control over this circumstance than it had over the ease with which George Henricksen was able to deposit a large portion of the checks into the couple's joint savings account and shortly thereafter withdraw such amounts without being discovered by the plaintiff.

With the benefit of hindsight, the plaintiff argues that Smith Barney's local managers should have drawn a connection between the large, continuous cash withdrawals and George Henricksen's personal problems, including the couple's separation. Awareness of these same problems did not trigger similar concern on the plaintiff's part which itself suggests that Smith Barney's supervision of Mr. Henricksen was not unreasonable or inadequate. On the contrary, I find that Smith Barney discharged its duty to supervise with reasonable diligence George Henricksen's withdrawals of cash from the plaintiff's account and therefore hold that Smith Barney is not jointly and severally liable for Mr. Henricksen's fraudulent conversion of the plaintiff's funds.

I also find that, considering all the circumstances, Smith Barney was reasonably diligent in its supervision of the quality of trading in the plaintiff's account. The plaintiff's investment objectives were relatively conservative when she opened the account in 1972, and, even after she signed an option agreement in 1975, the account retained a generally conservative quality. However, in light of the sweeping terms of the power of attorney the plaintiff executed in favor of George Henricksen, it is clear to me that he was given the power to make whatever investments he deemed suitable for the plaintiff's account. Thus, in discharging its duty to supervise with reasonable diligence Mr. Henricksen's actions, Smith Barney was entitled to rely on George Henricksen's investment decisions just as the plaintiff relied on her husband's expertise.

This approach finds support in Ocrant v. Dean Witter & Company, Inc., 502 F.2d 854 (10th Cir. 1974), and Marshak v. Blyth Eastman Dillon & Co., Inc., 413 F. Supp. 377 (N.D. Okla. 1975). In *Ocrant*, the court found an apparent agency relationship between the plaintiff wife and her husband and that the plaintiff relied exclusively on her husband to handle her investment account. What the court said in *Ocrant* is germane here:

> "Throughout this action [the plaintiff] has stressed her complete reliance on her husband's skill and expertise to excuse her own inattentiveness and inaction. She cannot now reject that reliance for purposes of disaffirming his activities." 502 F.2d at 858.

The *Marshak* court similarly held that, after relying on the manner in which her husband handled her account, the plaintiff could not disavow his control simply because problems subsequently arose. 413 F. Supp. at 381-83.

Of course, in this case, unlike *Ocrant* and *Marshak*, the husband upon whom the plaintiff relied was employed by the defendant broker, and the latter was duty-bound to supervise the husband's activities. I do not suggest that, by virtue of the agency relation, George Henricksen's knowledge must be imputed to the plaintiff, thereby estopping her from challenging the uncontroverted option transactions. I do believe, however, that the reasonableness of Smith Barney's supervision of George Henricksen must be evaluated in light of the express agency relationship which existed between Mr. Henricksen and the plaintiff and in light of Mr. Henricksen's investment experience.

Smith Barney's local managers, because they approved of each of Mr. Henricksen's orders, knew that the account was trading heavily in options. However, they also believed that George Henricksen was mitigating the impact of this trading by sheltering large amounts of cash in a savings account. On the one occasion when Mr. Henricksen clearly exceeded the ac-

count's approved level of trading by making an "uncovered" transaction, Smith Barney's compliance section required him to cover the transaction.

That the plaintiff's account incurred substantial losses as a result of options trading does not alone make Smith Barney's supervision unreasonable or indicate a lack of diligence. Rather, based on all the facts known to Smith Barney, including the power of attorney, the option agreement, George Henricksen's investment experience and his reported placing of large amounts of cash in a safe harbor, I am satisfied that the plaintiff's losses in options trading were not due to a failure on Smith Barney's part to supervise George Henricksen with reasonable diligence.

I also conclude that Smith Barney is not liable for the plaintiff's trading losses based on an alleged violation of the New York Stock Exchange's "know your customer" rule. In Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 143 (7th Cir.), *cert. denied,* 396 U.S. 838 (1969), the court held that a violation of this rule would constitute a violation of federal law in certain circumstances but that "mere errors of judgment by defendant might not support a federal cause of action...." In this case, Smith Barney's customer had given her broker-husband wide discretionary authority over her account, expressly ratifying whatever acts he might perform. She had also signed an option agreement and a margin contract. In these circumstances, Smith Barney was entitled to believe that George Henricksen was executing his wife's wishes. While this belief can be described as an error of judgment, in my opinion this error affords and insufficient basis upon which to base liability against Smith Barney.

CONCLUSION

Therefore, IT IS ORDERED that the plaintiff recover from the defendant George Henricksen the sum of $88,921.22, plus prejudgment interest on such sum computed at the rate of

5% per annum since November 1, 1977, plus the plaintiff's costs in this action.

IT IS ALSO ORDERED that the plaintiff recover from both defendants jointly and severally the sum of $21,754.65, plus prejudgment interest on such sum computed at the rate of 5% per annum since November 1, 1977.

IT IS FURTHER ORDERED that the defendant Smith, Barney Harris Upham & Co., Inc. may recover from the defendant George Henricksen any sum it pays to the plaintiff as a result of the above order.

IT IS FURTHER ORDERED that no costs be recovered from the defendant Smith, Barney, Harris Upham & Co., Inc.

Dated at Milwaukee, Wisconsin, this 10th day of March, 1980.

/s/ MYRON L. GORDON
U. S. District Judge

JUDGMENT ON DECISION BY THE COURT

UNITED STATES DISTRICT COURT
FOR THE
EASTERN DISTRICT OF WISCONSIN

WENDEE HENRICKSEN, Plaintiff,

vs.

GEORGE HENRICKSEN and SMITH, BARNEY, HARRIS, UPHAM & CO., INC., Defendants.

CIVIL ACTION FILE NO. 78-C-208

JUDGMENT

This action came on for trial before the Court, Honorable MYRON L. GORDON, United States District Judge, presiding, and the issues having been duly tried and a decision having been duly rendered,

It is Ordered and Adjudged that the plaintiff recover from the defendant George Henricksen the sum of $88,921.22, plus prejudgment interest on such sum computed at the rate of 5% per annum since November 1, 1977, plus the plaintiff's costs in this action.

IT IS ALSO ORDERED that the plaintiff recover from both defendants jointly and severally the sum of $21,754.65, plus prejudgment interest on such sum computed at the rate of 5% per annum since November 1, 1977.

IT IS FURTHER ORDERED that the defendant Smith, Barney, Harris Upham & Co., Inc. may recover from the defendant George Henricksen any sum it pays to the plaintiff as a result of the above order.

IT IS FURTHER ORDERED that no costs be recovered from the defendant Smith, Barney, Harris Upham & Co., Inc.

Dated at Milwaukee, Wisconsin, this 10th day of March, 1980.

RUTH W. LA FAVE
Clerk of Court

By:

Deputy Clerk

Office-Supreme Court, U.S.
FILED
JUL 25 1981
ALEXANDER L. STEVAS,
CLERK

IN THE
SUPREME COURT OF THE UNITED STATES
SUMMER TERM, 1981

NO. 80-2211

SMITH BARNEY, HARRIS
UPHAM & CO., INC.,

Petitioner,

vs.

WENDEE HENRICKSEN,

Respondent.

BRIEF FOR RESPONDENT

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Dated: July 23, 1981

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IN THE
SUPREME COURT OF THE UNITED STATES
SUMMER TERM, 1981

NO. 80-2211

SMITH BARNEY, HARRIS
UPHAM & CO., INC.,

Petitioner,

vs.

WENDEE HENRICKSEN,

Respondent.

BRIEF FOR RESPONDENT

STATEMENT OF THE CASE

The respondent Wendee Henricksen sued the petitioner Smith Barney, Harris Upham & Co., Inc. ("Smith Barney") and George Henricksen for the common law claim of conversion, the common law claim of breach of fiduciary duty, and for violations of the securities laws including sec. 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j) and Securities and Exchange Commission Rule 10b-5 (17 C.F.R. §240.10b-5). The claims against Smith Barney were based upon respondeat superior as to the common law claims and upon both respondeat superior and sec. 20(a) of the Securities Exchange Act of 1934 (15 U.S.C. §78t(a)) as to the securities law claims.

The respondent's claims were based on the fact that she deposited blue chip securities with a value of $113,000 into a Smith Barney discretionary account with a long-term growth investment objective in January of 1976 and that by November of 1977 her account had a value of zero. The trial court awarded the respondent complete recovery against George Henricksen and set forth the components of the damages as follows:

1. $55,356.91 of converted funds under both the common law claim of conversion and the securities law claim under sec. 10(b) and Rule 10b-5;

2. $33,564.31 of losses on call purchases under both the common law claim of breach of fiduciary duty and the securities law claim under sec 10(b) and Rule 10b-5; and

3. $21,754.65 of commissions and margin account interest under both the common law claim of breach of fiduciary duty and the securities law claim under sec. 10(b) and Rule 10b-5.

The trial court, however, only awarded the respondent recovery against Smith Barney as to the third element of the above damages.

The trial court held that Smith Barney had no liability under respondeat superior as to any of the claims, because the respondent had a discretionary account as opposed to a nondiscretionary account. The trial court held that this created a dual agency and thus eliminated the normal agency liability rules that would apply in an employment situation.

The trial court further held that Smith Barney had no liability under sec. 20(a) of the Securities

Exchange Act of 1934 as to the securities law claims, since the trial court found that Smith Barney had enforced its reasonably adequate system of internal supervision and control with reasonable diligence. In making this determination, the trial court again held that a discretionary account involved a dual agency. The trial court held that this created a lighter duty of supervision for Smith Barney.

The trial court's award of damages against Smith Barney as to the $21,754.65 of commissions and margin account interest was based upon the trial court's application of common law principles of unjust enrichment.

The respondent appealed to the United States Court of Appeals for the Seventh Circuit from that portion of the trial court's judgment denying recovery against Smith Barney. The essence of the respondent's appeal was that the trial court had made an error of law as to the nature of and duties flowing from a discretionary account. Smith Barney cross-appealed upon the basis that it should not have been found liable under unjust enrichment, if it was not liable under respondeat superior or sec. 20(a) of the Securities Exchange Act. George Henricksen did not appeal.

The Seventh Circuit held that the trial court had made an error of law as to the nature of and duties flowing from a discretionary account. The Court ruled that, in undertaking a discretionary account, Smith Barney actually "took upon itself a far more stringent fiduciary responsibility than it undertakes with respect to nondiscretionary accounts" (App. at A-12). The Seventh Circuit held that this error of law had affected the trial court's findings on both the respondeat superior issue and the sec. 20(a) issue.

The Seventh Circuit held that Smith Barney was liable to the respondent under respondeat superior

as to all of her damages under her common law claims and her securities law claims. As noted above, all of the respondent's recoveries against George Henricksen had an independent common law basis in addition to a securities law basis. The Seventh Circuit further held that Smith Barney also was liable to the respondent under sec. 20(a) as to all of her damages under her securities law claims which occurred after October of 1976.

Smith Barney then filed a petition for rehearing en banc which was denied.

Smith Barney then filed a petition for certiorari with this Court.

ARGUMENT

I. There is No Case or Controversy Before This Court.

There currently is no real case or controversy before this Court. This is due to the limited issues raised by Smith Barney in its petition for certiorari.

As set forth in the Statement of the Case, the respondent's entire recovery against George Henricksen has a common law basis in either conversion or breach of fiduciary duty. Smith Barney does not raise any issue as to its liability under the common law doctrine of respondeat superior for George Henricksen's common law violations of conversion and breach of fiduciary duty.

Smith Barney could not reasonably raise any such issue. For example, at page nine of its petition herein, Smith Barney cites the Ninth Circuit as one of the circuits which has held that sec. 20(a) is the exclusive means of vicarious liability of broker-dealers for the securities law violations of their employees. In Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980), the

plaintiff recovered a judgment against a broker-dealer and one of its employees under both a common law claim of breach of fiduciary duty and a securities law claim under sec. 10(b) and Rule 10b-5. On appeal the defendants raised an issue as to respondeat superior, which the Ninth Circuit disposed of as follows:

> "The contention that the Court incorrectly instructed the jury regarding the applicability of respondeat superior to a 10b-5 claim is also unsupported by the record. The Court gave the respondeat superior instruction in connection with the fiduciary duty claim, and limited it to that claim." (619 F.2d at p.825)

Smith Barney also does not contend that sec. 20(a) of the Securities Exchange Act has anything to do with the common law claims of conversion and breach of fiduciary duty. Sec. 20(a) provides that it only applies where one is "liable under any provision of this chapter or of any rule or regulation thereunder ...." Furthermore, sec. 28(a) of the Securities Exchange Act of 1934 provides that, "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity ...."

The respondent Wendee Henricksen, therefore, submits that a writ of certiorari in this matter would have no effect on the case and controversy between her and Smith Barney. She is entitled to complete recovery against Smith Barney based solely on her common law claims. The petition for certiorari should be denied on this basis alone.

II. Two of the Three Issues in the Petition for Certiorari were not Raised Below, and the Other Issue was Raised Only in the Petition for Rehearing.

Smith Barney raises three issues in its petition for certiorari. The first issue is as to respondeat superior liability of a broker-dealer for its employees' securities law violations. The second and third issues are as to the need for scienter on the part of a broker-dealer in order to be liable under sec. 20(a) for the securities act violations of its employees.

The first issue was raised only in Smith Barney's Seventh Circuit petition for rehearing en banc. In its brief on the appeal to the Seventh Circuit, Smith Barney raised no such issue. Its only reference to the matter of respondeat superior liability as to securities law violations was an aside in a footnote. (R. App. A-2)

The second and third issues as to scienter under sec. 20(a) were not raised in any manner, shape or form before the Seventh Circuit in either the appeal or the petition for rehearing. Neither the trial court nor the Seventh Circuit was ever called upon to determine whether Smith Barney was guilty of scienter within the facts of this case.

As to this manner of raising issues, this court has stated:

> "This issue was not raised in the Court of Appeals. Only in exceptional cases will this Court review a question not raised in the court below." Lawn v. United States, 355 U.S. 339, 362, fn. 16 (1958)

and

> "This Court sits as a court of review. It is only in exceptional cases coming here from the federal courts that questions not pressed or passed upon below are reviewed. [citations omitted]" Duignan v. United States, 274 U.S. 195, 200 (1927)

This Court has embodied this principle in Supreme Court Rule 15(g) which provides in relevant part that, "The statement of the case shall also specify the stage in the proceedings (both in the court of first instance and in the appellate court) at which the questions sought to be reviewed were raised; the method or manner of raising them; and the way in which they were passed upon by the court".

See also United States v. Santana, 427 U.S. 38, 41, fn. 2 (1976); United States v. Ortiz, 422 U.S. 891, 898 (1975); R. Stern and E. Gressman, Supreme Court Practice (5th Ed. 1978), sec. 6.27.

It is submitted that none of the issues in the petition for certiorari hearing were properly raised in the court below, and that certiorari should be denied on that basis alone.

III. The Position of Smith Barney as to Respondeat Superior Liability is Incorrect.

The respondent Wendee Henricksen chooses not to respond in any manner to the second and third issues as to scienter raised by Smith Barney on this petition, since those issues were not even hinted at at any place in this entire litigation until the filing of this petition for certiorari. At no time did Smith Barney argue to either the trial court or the appellate court that it was necessary that there be a determination as to the scienter of Smith Barney.

As to the issue of respondeat superior liability for securities law violations of a broker-dealer's employees, which issue was raised for the first time on the petition for rehearing, the respondent notes that these issues recently were squarely posed to the Second Circuit and Fifth Circuit. The respondent will rely on the explications of law in Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2nd Cir. 1980), cert. den. sub. nom. Wood Walker & Co. v. Marbury Management, Inc., 101 S. Ct. 566, 66 L. Ed.2d 469 (1980) and Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980), pet. for reh. en banc den., 634 F.2d 1355.

The respondent also notes that, contrary to the statement by Smith Barney in footnote 5 on page 9 of its petition, the United States Court of Appeals for the Third Circuit has changed its position on this issue and now would recognize the respondeat superior liability of a broker-dealer in addition to its sec. 20(a) liability for its employees' securities law violations. In Sharp v. Coopers & Lybrand, Fed. Sec. L. Rep. (CCH) ¶97,971 (3rd Cir. 1981), the Third Circuit, in discussing respondeat superior liability for employees' securities law violations, distinguished broker-dealers from other employers due to broker-dealers owing a higher duty to their customers. Indeed, the Third Circuit stated that the decision of the Seventh Circuit in this very case was consistent with the decision of the Third Circuit in that case and that the Third Circuit drew support from the Seventh Circuit decision in this case! (pages 91,013 - 91,014)

The respondent also notes that two Fourth Circuit panels have held that a broker-dealer has respondeat superior liability for the securities law violations of its employees. Johns Hopkins University v. Hutton, 422 F.2d 1124 (4th Cir. 1970), cert. den., 416 U.S. 916 (1974) and Carras v. Burns, 516 F.2d 251 (4th Cir. 1975). Another

panel, without citing the above two earlier decisions, has held that there is no such liability. Carpenter v. Harris, Upham & Co., Inc., 594 F.2d 388 (4th Cir. 1979), cert. den., 444 U.S. 868 (1979). Thus, the final position of the Fourth Circuit on this issue must await a future decision.

The respondent further agrees with the position of the Fifth Circuit in Paul F. Newton & Co. v. Texas Commerce Bank, (supra, at 630 F.2d 1117, fn. 5) which notes that the Ninth Circuit has never directly focused on the issue of a broker-dealer's respondeat superior liability for the securities law violations of its employees.

Thus, it is submitted that any split among the circuits as to the respondeat superior liability of broker-dealers for the securities law violations of their employees is healing.

CONCLUSION

There currently is no case or controversy between Wendee Henricksen and Smith Barney, since Smith Barney has raised no issue in its petition for certiorari as to its respondeat superior liability for the common law violations of conversion and breach of fiduciary duty.

Two of the three issues raised by Smith Barney in its petition for certiorari were never raised in any form whatsoever in either the Seventh Circuit or the trial court. The other issue was raised for the first time in Smith Barney's petition to the Seventh Circuit for a rehearing en banc.

The appeal to the Seventh Circuit revolved around the nature of a discretionary account and not around the issues that are now being raised by

Smith Barney. The petition for writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Docket Nos. 80-1488 and 80-1584

WENDEE HENRICKSEN,

Plaintiff-Appellant
and Cross-Appellee,

vs.

SMITH BARNEY, HARRIS UPHAM & CO., INC.,

Defendant-Appellee
and Cross-Appellant.

On Appeal From the United States District Court for the Eastern District of Wisconsin

---

BRIEF OF DEFENDANT-APPELLEE AND CROSS-APPELLANT SMITH BARNEY, HARRIS UPHAM & CO., INC.

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[Excerpt from page 26]

Observing the rule this circuit established in Fey v. Walston & Co., Inc., 493 F.2d 1036 (7th Cir. 1974), the district court held that even though not liable under Section 20(a) of the Securities and Exchange Act of 1934, Smith Barney could conceivably be liable for George Henricksen's conduct under a respondeat superior theory.[15]

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[15] Other circuits are divided on the issue of whether respondeat superior should even be considered a basis for relief independent of Section 20(a) of the Securities and Exchange Act of 1934. Compare, Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 667 (9th Cir. 1978) ("the established law of [the 9th] Circuit [is] that section 20(a) supplants vicarious liability of an employer for the acts of an employee applying the respondeat superior doctrine.") with, Marbury Management, Inc. v. Kohn et al, CCH Fed. Sec. L. Rptr. ¶97,357 (2d Cir. 1980). The circuits refusing to expand the scope of brokerage firm liability to include liability under the respondeat superior theory are clearly correct. Like allowing a private cause of action for a merely negligent violation of an association or stock exchange rule, permitting liability under the doctrine of respondeat superior would nullify "the carefully drawn restrictions surrounding the major anti-fraud provisions of the Exchange Act." See, Zagari v. Dean Witter & Co., Inc., CCH Fed. Sec. L. Rptr. §95,777 at p. 90,812 (N.D. Cal. 1976).

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No. 80-2211

IN THE
SUPREME COURT OF THE UNITED STATES

Summer Term, 1981

SMITH BARNEY, HARRIS
UPHAM & CO., INC.,

Petitioner,

v.

WENDEE HENRICKSEN,

Respondent.

On Writ of Certiorari
To the United States Court of Appeals
For the Seventh Circuit

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No. 80-2211

IN THE
SUPREME COURT OF THE UNITED STATES

Summer Term, 1981

SMITH BARNEY, HARRIS
UPHAM & CO., INC.,

Petitioner,

v.

WENDEE HENRICKSEN,

Respondent.

On Writ of Certiorari
To the United States Court of Appeals
For the Seventh Circuit

REPLY BRIEF FOR PETITIONER

ARGUMENT

I. THERE EXISTS A CASE AND CONTROVERSY REGARDING A CONFLICT BETWEEN §20(a) OF THE 1934 ACT AND FEDERAL COMMON LAW BECAUSE (A) THE COURT OF APPEALS IMPOSED SECONDARY LIABILITY ON SMITH BARNEY UNDER THE COMMON LAW DOCTRINE OF *RESPONDEAT SUPERIOR* WITHOUT DISTINGUISHING GEORGE HENRICKSEN'S VIOLATIONS OF §10(b) OF THE ACT FROM HIS COMMON LAW

TORTS, AND SECONDARY LIABILITY FOR VIOLATION OF A FEDERAL STATUTE MUST BE DETERMINED UNDER FEDERAL LAW; AND (B) FEDERAL LAW MUST HAVE DETERMINED SMITH BARNEY'S SECONDARY LIABILITY FOR GEORGE'S PRE-NOVEMBER, 1976 FRAUDULENT CONVERSION OF WENDEE'S FUNDS BECAUSE WISCONSIN LAW CLEARLY DOES NOT IMPOSE SUCH LIABILITY.

The first question presented by Smith Barney's Petition, as stated in an article which very recently appeared in the *New York Law Journal,*[1] is "whether an employer is liable for the acts of its employees both under the controlling person provisions of securities laws and under the common law principle of *respondeat superior.*" Respondent Wendee Henricksen contends that this issue is moot because the court of appeals held Smith Barney secondarily liable under *respondeat superior* for its employee George Henricksen's common law violations (breach of fiduciary duty and conversion), as to which secondary liability there is no dispute. Respondent misses two points.

First, the court of appeals did not say whether Smith Barney was liable under *respondeat superior* for George's common law violations, or for his §10(b) violations. If the latter, then the question presented must be resolved. Since that cannot be determined, the question is not academic and a "case or controversy" exists. *Buckley v. Valeo,* 424 U.S. 1, 12, 46 L.Ed.2d 659, 96 S.Ct. 612 (1976); *Aetna Life Ins. Co. v. Haworth,* 300 U.S. 227, 241, 81 L.Ed.2d 617, 57 S.Ct. 461 (1967).

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[1]Edward Brodsky, "Corporate And Securities Litigation: Controlling-Person Liability — A Conflict", 186 *N.Y.L.J.* 10 (July 15, 1981) at p. 1. This issue has received substantial scholarly examination, particularly since this Court's ruling in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 47 L.E.2d 668, 96 S.Ct. 1375 (1976). *See, e.g.,* Fischel, "Secondary Liability Under Section 10(b) of the Securities Act of 1934", 69 *Calif. L. Rev.* 80 (1981); Ruder, "Secondary Liability Under the Securities Acts", *Eighth Annual Institute on Securities Regulation* (P.L.I. 1977).

In any event, if the court of appeals determined that Smith Barney was liable under the state common law doctrine of *respondeat superior* for George's conversion of funds from the couple's joint savings account before November, 1976 ($39,721.11), it clearly erred because Wisconsin law does not impose such liability. A case or controversy exists because the only available source of secondary liability in this case was federal common law. The viability of a federal common law doctrine of *respondeat superior* in federal securities cases is the nub of the controversy presented in the Petition.

A. Neither The District Court Nor The Court Of Appeals Distinguished Theories Of Primary Liability In Determining Smith Barney's Secondary Liability.

In the Seventh Circuit, respondent argued that:

> " . . . a brokerage firm's liability for its employee's violation of Sections 17(a), 10(b) and 15(c)(1) of the Securities and Exchange Act of 1934 rests upon Section 20(a) of the 1934 Act and the *respondeat superior* doctrine." (Plaintiff-Appellant's Brief at 25).

This raises the precise issues set forth in the Petition: whether the requirements of §20(a) are satisfied in this case and whether *respondeat superior* is available as a broader alternative to §20(a). As her secondary-liability issue on appeal, respondent expressly urged *respondeat superior* liability for securities law violations, without any reference to or reliance on common law theories of conversion or breach of fiduciary duty.

In considering whether Smith Barney had secondary liability, neither the district court nor the court of appeals distinguished between secondary liability for common law violations and secondary liability for §10(b) violations. The district court held George accountable for common law conversion and breach of fiduciary duty as well as violation of §10(b). (Pet. App. D-10 to D-12.) Turning to Smith Barney's secondary liability, it distinguished between the option losses and the converted funds, but not between George's §10(b) and common law liabilities. (Pet. App. D-15 to D-22.) Nor did the

court of appeals make or rely on the latter distinction. It discussed "the common law doctrine of *respondeat superior*" only with respect to Smith Barney's "liability for the unlawful acts of its agent, George . . . . " (Pet. App. A-13.) Respondent does not and cannot contest the existence of a case or controversy if, as she urged in the court below, Smith Barney's liability was based on the §10(b) violations. The manner in which the issue of secondary liability was argued to and decided by the courts below thus ensures the continuation of a case and controversy on the issues presented in the Petition.

B. The Wisconsin Law Of *Respondeat Superior* Furnished No Basis For Imposition Of Secondary Liability On Smith Barney.

Although the court of appeals referred to "state common law" in imposing strict *respondeat superior* liability on Smith Barney (Pet. App. A-15), the decision does not refer to a single Wisconsin case dealing with conversion, breach of fiduciary duty, or *respondeat superior.* Instead, the court derived its *respondeat superior* standard from *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1052-53 (7th Cir. 1974) (Pet. App. A-13), a federal case which in turn cites only federal *respondeat superior* cases. It was in reliance on these federal cases — which apparently apply federal common law — that the court held Smith Barney strictly liable for George's pre-November, 1976 violations.[2] The point of Smith Barney's Petition is that such federal common law cannot co-exist with §20(a), a federal statute to the contrary.

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[2]The Seventh Circuit in *Fey v. Walston & Co., Inc., supra,* 493 F.2d 1052, n. 19 adopted, without reference to any state's law, the Eighth Circuit's statement of a "common law principle" that "a principal is liable for the deceit of its agent committed in the very business he was appointed to carry out." *Myzel v. Fields,* 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968). The circuits which have applied this to impose secondary liability in federal securities cases appear to rely on federal law. *See* Fischel, "Secondary Liability Under Section 10(b) of the Securities Act of 1934", 69

(footnote continued)

It is not surprising that the court of appeals did not explain its cryptic reference to "state common law" in holding Smith Barney secondarily liable. The district court's findings of fact are clearly inconsistent with liability under Wisconsin law. Wisconsin's doctrine of *respondeat superior* holds a principal liable for his agent's acts within the scope of his apparent authority, including acts which are fraudulent or against the principal's interest. *Hollingsworth v. American Finance Corporation,* 86 Wis.2d 172, 181, 271 N.W.2d 872, 877 (1978). This requires particularized inquiry into whether the principal's conduct reasonably induced the third party to believe that the agent had authority to act for the principal. *Id.* at 183. To establish apparent authority for the purpose of applying *respondeat superior* in Wisconsin, three elements must be established: (1) acts by the agent or principal which would justify a belief in the agent's authority; (2) the principal's knowledge of such acts; and (3) reliance on the acts by the third party, consistent with ordinary care and prudence. *Silberman v. Roethe,* 64 Wis.2d 131, 151-152, 218 N.W.2d 723, 733 (1974); *Rivera v. Eisenberg,* 95 Wis.2d 384, 393-394, 290 N.W.2d 539, 544 (1980).

The district court's findings of fact preclude Smith Barney's liability under Wisconsin law. The pre-November, 1976 losses occurred when George withdrew funds from his and Wendee's joint savings account. George withdrew the money from the joint account in his capacity as a co-depositor and pursuant to his authority under the deposit contract with the bank. The district court made no finding that Smith Barney purported to tell, or should have told, Wendee how to manage her personal banking affairs. In fact, the district court found that she "could easily have prevented or at least quickly

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Calif. L. Rev. 80 (1981) at 87, n. 41. It remains Smith Barney's position that even this federal formulation was inapplicable here,because George's withdrawal of funds from his and Wendee's joint bank savings account was not a "deceit [the] agent committed in the very business he [George] was appointed [by Smith Barney] to carry out." *See* Petition at pp. 7-8.

detected her husband's fraud by taking reasonable precautionary steps which the facts known to her required." (Pet. App. D-17.) These findings of fact precluded the court of appeals from holding — even implicitly — that Wendee relied on some act of Smith Barney or its agent in a manner "consistent with ordinary care and prudence." *See Motor Castings Co. v. Milwaukee County Bank,* 254 Wis. 493, 36 N.W.2d 687 (1949). Since the found facts compel the conclusion that George's acts were without the scope of his apparent authority, Wisconsin law prohibits the imposition of *respondeat superior* liability.

Respondent's argument that the court of appeals' decision is explainable by reference to state law is unsupportable, because it presumes that that court erred in applying the state common law upon which the argument relies. The only viable interpretation of the court of appeals' decision is that, under federal statutory and common law, strict secondary liability was imposed on Smith Barney for the acts of its registered representative. Whether this ruling is correct is the central issue presented for review in the Petition.

II. ALL ISSUES WERE TIMELY RAISED AS SOON AS THEY BECAME ISSUES IN THESE PROCEEDINGS.

Respondent contends that the three questions presented in Smith Barney's Petition were not raised in a timely manner and should not be considered by this Court (Respondent's Brief, p. 6). Respondent asserts that the first question (relating to *respondeat superior*) was not raised until Smith Barney petitioned the court of appeals for rehearing, and that the second and third questions (relating to *scienter*) were first raised in Smith Barney's Petition.

Smith Barney's first question, regarding the applicability of *respondeat superior,* was not raised prior to the petition for rehearing because Smith Barney had no reason to do so until the court of appeals based its decision on that doctrine.[3]

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[3]Plaintiff-respondent pleaded *respondeat superior,* and succinctly argued that theory in her post-trial brief (at pp. 43-44). Smith

(footnote continued)

Although not phrased in terms of the *scienter* requirement of *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 47 L.E.2d 668, 96 S.Ct. 1375 (1976), Smith Barney's second and third questions were the focus of the entire trial and appeal process. Because Smith Barney raised the "good faith" defense afforded by §20(a) of the Act, much of the evidence received during the trial related to whether Smith Barney had any intent to deceive or was reckless or negligent in its supervision of Wendee's account. The parties fully litigated the issue of *scienter* without calling it that. The district court addressed Smith Barney's culpability at length in its opinion (Pet. App. D-16, D-17, and D-19 to D-22), as did the court of appeals. (Pet. App. A-9 to A-13).

In certiorari proceedings, questions are timely raised if they are presented for the first time in the petition for writ of certiorari. In *Friedman v. Rogers,* 440 U.S. 1, 59 L.Ed.2d 100, 99 S.Ct. 887 (1979), the Court refused to consider a claim that "was neither alleged in the District Court nor mentioned in the jurisdictional statement in this Court", 440 U.S. at p. 19, n. 20. This statement implies that the claim would have been

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Barney in its post-trial brief noted the split between circuits on the issue (at p. 30), not arguing the point because the trial court was unquestionably bound by *Fey v. Walston & Co., Inc.,* 493 F.2d 1036 (7th Cir. 1974). On appeal from the trial court's decision, denying liability under §20(a) as well as *respondeat superior,* appellant Wendee devoted thirty-six pages of her thirty-eight page brief to the proposition that Smith Barney inadequately supervised the account. She cited *respondeat superior* as an alternative basis for secondary liability (pages 24-26) without elaboration. At that stage, the focus was on the facts — not on legal theories. Smith Barney in its brief (as appellee) defended the district court's decision in response to Wendee's arguments that her account was inadequately supervised. Smith Barney did not address the issue of *respondeat superior* at that point because the focus was on the facts and because the Seventh Circuit, in *Fey v. Walston & Co., Inc.,* 493 F.2d 1036, 1052-53 (7th Cir. 1974), had already resolved the *respondeat superior* question against Smith Barney.

timely if it had been raised in either the district court *or* the jurisdictional statement. The same reasoning is implicit in *Dorszynski v. United States,* 418 U.S. 424, 431, n. 7, 41 L.Ed.2d 855, 94 S.Ct. 3042 (1974) and *Espinoza v. Farah Manufacturing Co.,* 414 U.S. 86, 96, n. 9, 38 L.Ed. 2d 287, 94 S.Ct. 334 (1973). It follows that the issues here, properly presented in the Petition, have been timely raised for review by this Court.[4]

III. THE CONFLICT OF AUTHORITY BETWEEN CIRCUITS IS CLEAR AND CONTINUING.

Respondent finally argues that there is no real conflict between the circuits concerning the relationship between the federal securities laws and the common law doctrine of *respondeat superior* (Respondent's Brief, p. 9). That the conflict continues to exist and concerns the securities bar is emphasized by Edward Brodsky's recent column, "Corporate And Securities Litigation: Controlling-Person Liability — A Conflict", on the front page of the July 15, 1981 *New York Law Journal* (Vol. 186, No. 10). Mr. Brodsky writes:

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[4]Respondent cites four cases in support of her contention that Smith Barney did not raise its issues in a timely fashion. None of these cases is on point. In *Lawn v. United States,* 355 U.S. 339, 362 n. 16, 2 L.E.2d 321, 78 S.Ct. 311 (1958), the Court refused to consider an issue which was not even raised in the petition for a writ of certiorari. That is not the situation here. In *Duignan v. United States,* 274 U.S. 195, 200,71 L.E. 996, 47 S.Ct. 566 (1927), the Court refused to consider a challenge to the constitutionality of a federal statute which was first raised in the petition for writ of certiorari. No such challenge is presented by Smith Barney. The third case cited is *United States v. Santana,* 427 U.S. 38, 41, n. 2, 49 L.E.2d 300, 96 S.Ct. 2406 (1976), where (applying the rule that challenges to standing are waived if not presented at trial) the Court declined to consider an issue of standing which was not presented at trial. This case has nothing to do with the stage at which a non-standing issue must be raised. In *United States v. Ortiz,* 422 U.S. 891, 898,45 L.E.2d 623, 95 S.Ct. 2585 (1975), the government asserted a position on an issue which was contrary to its position on that issue before the court of appeals. Respondent has not even suggested that Smith Barney has changed its position in this sense.

> "Courts continue to disagree on the issue of liability of employers for the fraud of their employees under the controlling person provisions of the federal securities laws . . . . The problem is complicated because of conflicts on two separate questions. First, there is the issue of whether an employer is liable for acts of its employees both under the controlling person provisions of securities laws and under the common law principle of *respondeat superior*. The Second, Fourth, Fifth, Sixth, and Seventh Circuits hold that the employer is liable under both theories while the Third and Ninth Circuits reach the opposite conclusion . . . . " (footnotes omitted).

The conflict is substantial. The Ninth Circuit steadfastly rejects the imposition of *respondeat superior* liability for securities violations.[5] The Eighth Circuit has declared that secondary liability in securities cases is not controlled by agency principles. *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967). The Third Circuit takes the same position as a general rule, with increasing exceptions.[6] At least one panel of the

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[5]*Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814 (9th Cir. 1980) does not (as respondent suggests) authorize the imposition of *respondeat superior* liability for a securities violation. (Respondent's Brief, pp. 4, 5). The conflict between common law and the securities statutes is never addressed in *Mihara*; §20(a) of the Securities Exchange Act is not mentioned in the opinion. The language respondent quotes indicates only that a brokerage firm may have *respondeat superior* liability for a common law wrong. Respondent also relies on a Fifth Circuit statement to the effect that the Ninth Circuit has never taken a definitive stand on the issue presented. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1117, n. 5 (5th Cir. 1980). Yet the Ninth Circuit has never retreated from its express holding that §20(a) "supplants" the common law of *respondeat superior* in securities cases. *Christoffel v. E. F. Hutton & Co., Inc.*, 588 F.2d 665, 667 (9th Cir. 1978).

[6]The law in the Third Circuit is confused. Respondent cites *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3rd Cir. 1981), which

(footnote continued)

Fourth Circuit agrees with the Eighth and Ninth Circuits. Other circuits which have addressed the issue impose strict liability on a "controlling person" under the common law doctrine of *respondeat superior*, despite the Congressional declaration in §20(a) of the Act that a "good faith" defense may be raised to the imposition of secondary liability. Regardless of how many panels in how many circuits line up on the respective sides of this issue, the fact remains that there is disagreement among the circuits and even within at least one circuit. This underscores the importance of a resolution by this Court of the questions presented in Smith Barney's Petition.

Respectfully submitted,

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dealt with the secondary liability of an accounting firm whose employees had improperly prepared documents in a securities transaction. Although the case did not involve stockbrokers or a brokerage firm, the Third Circuit in *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 886 (3rd Cir. 1975) suggested, in dictum, that it might favor a broader approach to liability in a stockbroker fraud case, implying that *respondeat superior* as well as §20(a) might render a brokerage firm liable for its employee's fraud. Yet both panels affirmed the general principal that only the secondary liability provisions of the securities laws may be used to hold a controlling person liable in securities cases. *Sharp v. Coopers & Lybrand*, *supra* at pp. 180-181. The Third Circuit's advisory dicta evidence the confusion surrounding §20(a) and the need for this Court to dispel it.

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In the Supreme Court of the United States

OCTOBER TERM, 1981

SMITH BARNEY, HARRIS UPHAM & CO., INC.,
PETITIONER

v.

WENDEE HENRICKSEN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a securities broker-dealer firm is subject to liability under the doctrine of respondeat superior for the fraudulent conduct of its employee in violation of Section 10(b) of the Securities Exchange Act.

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In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 80-2211

SMITH BARNEY, HARRIS UPHAM & CO., INC.,
PETITIONER

v.

WENDEE HENRICKSEN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

Petitioner Smith Barney, Harris Upham & Co., Inc. ("Smith Barney") is a broker-dealer firm registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (Pet. 4). Respondent Wendee Henricksen brought this action in the United States District Court for the Eastern

District of Wisconsin against Smith Barney and her former husband, George Henricksen, who was an employee of the firm, to recover losses sustained as a result of Mr. Henricksen's fraudulent conduct in handling her discretionary securities account. Mrs. Henricksen alleged that Mr. Henricksen was liable for violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, promulgated thereunder (Pet. App. D-1), and that Smith Barney also was liable for her losses both under the controlling-person provision of Section 20(a) of the Securities Exchange Act, 15 U.S.C. 78t(a), and under the common law doctrine of respondeat superior.[1]

The district court, after a non-jury trial, held Mr. Henricksen liable for (1) his wife's trading losses from unauthorized options trading; (2) brokerage commissions and interest expenses incurred by her as a result of the unauthorized trading; and (3) amounts that Mr. Henricksen had converted by selling securities in her account, endorsing Smith Barney's checks representing the proceeds of the sales, depositing those checks in the couple's joint bank account, and subsequently withdrawing a like amount in cash (Pet. App. A-7). With respect to Smith Barney, the trial court rejected the claim that the firm was liable, under the doctrine of respondeat superior and under Section 20(a) of the Securities Exchange Act, for all losses caused by the wrongful conduct of its employee (Pet. App. A-7). The court ruled, however, that the firm was liable to Mrs.

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[1] The complaint also alleged claims based on state common law and certain rules of the New York Stock Exchange and the National Association of Securities Dealers, Inc. (Pet. App. D-1).

Henricksen for the commissions and interest expenses she had incurred in connection with the options trading in her account, because Smith Barney would be unjustly enriched if it were allowed to profit from Mr. Henricksen's fraudulent conduct (*ibid.*).

The court of appeals reversed, concluding that Smith Barney was liable for all categories of damages. In the view of the court, the firm was liable under Section 20(a) of the Act, based on its failure adequately to supervise the account, for respondent's trading losses, for her commission and margin expenses, and for the conversion of funds from her account after the date the firm should have conducted a full review of her account as required by its internal procedures (Pet. App. A-13). The court of appeals further concluded that under the common law doctrine of respondeat superior Smith Barney was liable for all of the funds converted from Mrs. Henricksen's account, not just those converted after a review should have occurred (Pet. App. A-15).

DISCUSSION

The decision of the court of appeals applying the doctrine of respondeat superior to sustain liability under the federal securities laws does not conflict with any decision of this Court and is in accord with the prevailing view of the courts of appeals. Nevertheless, because of the importance of the doctrine of respondeat superior in providing investors a means of redress for losses incurred as a result of violations of the federal securities laws and because of a conflict among the circuits, we believe that this case warrants review by this Court.

1. Respondeat superior is a common law principle of secondary liability and generally "summarizes the

doctrine that a master or other principal is responsible, under certain conditions, for the conduct of a servant or other agent * * *."[2] A common application of that doctrine is the liability of an employer for a tort committed by its employee while acting within the scope of his employment,[3] or for a misleading statement made by an employee or other agent with actual or apparent authority.[4]

The applicability of respondeat superior to Section 10(b) violations rests upon the authority of the federal courts to look to fundamental common law principles when enforcing federally created rights, when such principles are necessary to effectuate the congressional purpose. This is particularly true in corporate litigation, a field in which common law agency principles, including the doctrine of respondeat superior, have long been utilized by the federal courts in fashioning remedies under various federal statutes. See *United States* v. *A & P Trucking Co.*, 358 U.S. 121, 125 (1958) (Motor Carrier Act); *New York Central & Hudson River R.R.* v. *United States*, 212 U.S. 481, 493 (1909) (Elkins Act); *United States* v. *Hilton Hotels Corp.*, 467 F.2d 1000, 1004 (9th Cir. 1972), cert. denied, 409 U.S. 1125 (1973) (Sherman Act). In *Gleason* v. *Seaboard Air Line Ry.*, 278 U.S. 349, 356 (1929), this Court, in applying the doctrine of respondeat superior in a diversity case, observed that "few doctrines

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[2] Seavey, *Speculations as to "Respondeat Superior,"* Harvard Legal Essays 433 (1934).

[3] *Restatement (Second) of Agency* § 219(1) (1958).

[4] *Id.* at §§ 257, 261.

of the law are more firmly established or more in harmony with accepted notions of social policy than that of the liability of the principal without fault of his own."

That agency principles are required to effectuate the congressional purpose embodied in Section 10(b) is demonstrated by the language of the statute. Section 10(b) makes unlawful fraudulent conduct by any "person," a term defined to include "company."[5] Since a corporation or other company can act only through its employees, the liability of such an entity for violations of Section 10(b) is necessarily based upon, and Congress must have intended the utilization of, common law principles traditionally employed by courts to hold corporations and other entities liable for the acts of their agents or employees. See *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975).[6] Moreover, as the Fifth Circuit recently commented, "[i]t is consistent with

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[5] Section 3(a)(9) of the Securities Exchange Act, 15 U.S.C. 78c(a)(9); see also 1 U.S.C. 1.

[6] In *United States* v. *A & P Trucking Co., supra*, 358 U.S. at 124, this Court held that a partnership may be held criminally liable for "knowingly" and "willfully" violating provisions of the Motor Carrier Act which proscribe certain conduct by any "person," a term defined by the Act to include partnerships. In that case, this Court rejected the argument that a partnership cannot be criminally liable since a partnership, as opposed to its individual partners, cannot act with a specific intent. In so doing, this Court stated (*id.* at 125):

> But the same inability to act *in fact* is true, of course, with regard to corporations and other associations; yet it

the remedial purpose of the federal securities acts" to require the employer to pay damages to its employee's victim when the employer "provides an employee with the means to carry out fraudulent practices * * *." *Paul F. Newton & Co.* v. *Texas Commerce Bank*, 630 F.2d 1111, 1118-1119 (5th Cir. 1980). This is particularly true in the context of the securities brokerage business where investors open accounts with the firm itself—as Mrs. Henricksen did—and they rely not only on the ability and integrity of the employee, but also, and in many cases primarily, on the reputation of the brokerage firm, enhanced by nationwide advertising. Indeed, so well established is the application of agency principles in corporate litigation under Section 10(b) and Rule 10b-5, that, in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 146-149 (1972), this Court imposed liability on a bank for the fraudulent conduct of its employees with only the terse statement "[t]he liability of the bank, of course, is coextensive with that of [its employees]." *Id.* at 154.

2. The decisions of the courts of appeals lack unanimity on the issue of whether respondeat superior is an appropriate basis for secondary liability under the federal securities laws. The prevailing view among the federal courts, exemplified by decisions of the United States Courts of Appeals for the Second, Fourth, Fifth, Sixth, Seventh and Tenth Circuits, is that respondeat superior may be utilized to hold employers liable for the fraudulent conduct of their employees in violation of provisions of the federal

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is elementary that such impersonal entities can be guilty of "knowing" or "willful" violations of regulatory statutes through the doctrine of *respondeat superior*.

securities laws.[7] The Court of Appeals for the Ninth Circuit, on the other hand, has held that agency principles such as respondeat superior are not applicable and that an employer's liability for violations of the Securities Exchange Act must be determined solely under the controlling-person provision of Section 20(a) of that Act. *Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1132-1133 (9th Cir.), cert. denied, 423 U.S. 1025 (1975); *Christoffel* v. *E.F. Hutton & Co.*, 588 F.2d 665, 667 (1978). The Court of Appeals for

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[7] See, *e.g.*, *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F.2d at 812-813; *Johns Hopkins University* v. *Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970); *Paul F. Newton & Co.* v. *Texas Commerce Bank*, *supra*, 630 F.2d at 1118-1119; *Holloway* v. *Howerdd*, 536 F.2d 690, 694-695 (6th Cir. 1976); *Fey* v. *Walston & Co.*, 493 F.2d 1036, 1052 (7th Cir. 1974); *Carroll* v. *First National Bank of Lincolnwood*, 413 F.2d 353, 358 (7th Cir. 1969), cert. denied, 396 U.S. 1003 (1970); *Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731, 741 (10th Cir. 1974).

Contrary to petitioner's contention (Pet. 9), *Carpenter* v. *Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), cert. denied, 444 U.S. 868 (1979), did not overrule the prior position of the Fourth Circuit. In *Carpenter*, the plaintiff sought to hold a brokerage firm liable for the conduct of its registered representative occurring *after* the representative left the employment of the firm (*id.* at 390) and thus the court did not reach the issue of the applicability of respondeat superior principles. Nor does *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968), represent a rejection of respondeat superior liability by the Eighth Circuit. The *Myzel* court did not consider the applicability of respondeat superior principles since the case did not arise in the employment context and the court found, on the facts of that case, that the defendants were liable under Section 20(a). 386 F.2d at 738. See *Zweig* v. *Hearst Corp.*, *supra*, 521 F.2d at 1132.

the Third Circuit has adopted an intermediate position that precludes the general application of agency principles under the federal securities laws except in cases involving broker-dealer firms or accounting firms, which, in the court's view, are under a strict duty of supervision and, therefore, are properly subject to respondeat superior liability.[8]

3. Contrary to petitioner's argument (Pet. 11), respondeat superior liability is not inconsistent with the statutory good faith and non-inducement defense provided under the controlling-person provision in Section 20(a). That Section was intended to supplement rather than curtail the common law liability of employers for the fraudulent acts of their em-

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[8] See *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175, 185 (1981), petition for cert. pending, No. 81-433; *Rochez Brothers* v. *Rhoades*, 527 F.2d 880, 886 (1975). The commentators are likewise split on whether vicarious liability may be imposed for violations of the federal securities laws under the doctrine of respondeat superior. Compare Reininger, *Exclusive or Concurrent—The Role of Control and Respondeat Superior in the Imposition of Vicarious Civil Liability on Broker-Dealers*, 9 Sec. Reg. L. Rev. 226 (1981); Comment, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 Calif. L. Rev. 1513 (1981); Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward an Improved Analysis*, 126 U. Pa. L. Rev. 1345 (1978) (favoring application of respondeat superior); with Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Calif. L. Rev. 80 (1981); Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities and Exchange Act*, 15 Calif. W.L. Rev. 152 (1979) (opposing application of respondeat superior). The American Law Institute's *Federal Securities Code* would preserve the applicability of agency principles. See ALI, *Federal Securities Code* § 202(86)(C), and Comment 3(b) to § 1724 (1980).

ployees. The controlling-person provisions of the securities laws were enacted

> to address the specific evil of persons seeking to evade liability under the acts by organizing "dummies," that, acting under their control, would commit the prohibited acts.[9]

Thus, "[the legislative] history does not reflect any congressional intent to restrict secondary liability for violations of the acts to the controlled persons formula * * *." *Paul F. Newton & Co.* v. *Texas Commerce Bank, supra*, 630 F.2d at 1118. There is no suggestion in the legislative history that Congress intended in 1934 to sweep away sub silentio the well-established doctrine of respondeat superior, which this Court in *New York Central & Hudson River R.R.* v. *United States, supra*, 212 U.S. at 494, described as "in the interest of public policy." Rather, Section 20(a) was intended to impose liability on controlling persons such as controlling shareholders or corporate officers, who would not be liable under

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[9] *Paul F. Newton & Co.* v. *Texas Commerce Bank, supra*, 630 F.2d at 1118. Although Section 20(a) on its face appears to apply to the employment or agency situation since the employer may be said to "control" its employee, the legislative history indicates that Congress did not enact that Section for the purpose of dealing with the employer-employee relationship. In describing the provision that eventually became Section 20(a), Thomas C. Corcoran, a spokesman for the drafters of the 1934 Act (see *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (1976)), testified: "The purpose is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section." *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 6571 (1934).

respondeat superior because they are not the actual employer. Section 20(a) expanded common law notions of secondary liability and, in so doing, created specific defenses available only to those who, under common law respondeat superior, would have faced no liability at all.

Far from undercutting the statutory scheme, the availability of relief against employers based on respondeat superior renders that scheme both equitable and coherent. For example, in the securities brokerage firm situation, the employee who personally committed the violation would be primarily liable to the customer, based on proof of that employee's own acts or omissions and, where it is an element, his scienter. His employer, the brokerage firm, would be secondarily liable to the customer—without proof as to its own separate fault—for violations committed by its employee acting within the scope of his employment. Other persons who are not subject to respondeat superior liability but nevertheless control the primary wrongdoer could be held liable under Section 20(a) of the Securities Exchange Act or other relevant controlling-person provisions.[10] Because the liability of persons in this latter category represents an expansion of liability beyond that imposed by common law, they are afforded statutory defenses not available in an employer-employee context. Thus, controlling persons may avoid liability under Section 20(a) by demonstrating that they acted in "good

[10] In contrast, in *Rochez Brothers* v. *Rhoades, supra,* 527 F.2d at 891, the court held that the corporation was not subject to Section 20(a) because it did not control its president who committed the fraud; rather, the president controlled the corporation and they "cannot simultaneously be 'controlling persons' as to each other." But see *SEC* v. *First Securities Co. of Chicago,* 463 F.2d 981, 987 (7th Cir.), cert. denied, 409 U.S. 880 (1972).

faith" within the meaning of that Section, *i.e.*, that their conduct was no worse than negligent. See *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 209 n.28.

Conversely, permitting controlling-persons who acted negligently to avoid liability under Section 20(a) is appropriate only if employers are subject to strict liability under respondeat superior. The public would have little protection if, for example, a broker-dealer could evade all responsibility to a customer for the fraud of the firm's salesman by demonstrating that it was merely negligent in failing to discover the wrongdoing. Under such circumstances, to permit an employer to assert the defenses contained in Section 20(a) would mean that the federal securities laws would provide *less* protection for defrauded persons than does common law or state law—surely an anomalous result that Congress did not intend in a statute designed to expand investor protection.[11]

4. Finally, petitioner incorrectly contends that imposition of respondeat superior liability is inconsistent with this Court's decision in *Ernst & Ernst* v. *Hochfelder*, *supra*, holding that scienter is a necessary element of violations of Section 10(b) as implemented by Rule 10b-5 (Pet. 11). In response

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[11] Nor does respondeat superior impose "insurer's" liability on the part of employers as petitioner suggests (Pet. 10). As one court has noted,

> [t]he familiar requirements of agency that the agent act within the course and scope of his employment and that he act within his actual or apparent authority serve to restrict the scope of the principal's liability.

Paul F. Newton & Co. v. *Texas Commerce Bank*, *supra*, 630 F.2d at 1119.

to an argument analogous to that of petitioner, in *United States* v. *A & P Trucking Co., supra,* 358 U.S. at 125, involving criminal charges, this Court characterized as "elementary" the proposition that "entities can be guilty of 'knowing' or 'willful' violations of regulatory statutes through the doctrine of *respondeat superior.*" As is implicit in this Court's decision in that case, the doctrine of respondeat superior does not undermine the elements of liability necessary to establish a violation, but merely serves to identify those persons who may be held vicariously liable for that violation.[12] With respect to a violation of Rule 10b-5, the culpability requirement, like all other elements, must therefore be satisfied by the state of mind or conduct of the primary wrongdoer as was the case here. The application of respondeat superior does no violence to the statutory scheme and is consistent with the settled principle that a corporation acts only through its employees and must bear responsibility for their acts. See *United States* v. *A & P Trucking Co., supra.*

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[12] See Margolis, *Sanctions Against Accountants for Violations of the Securities Laws: A Reappraisal,* 4 Del. J. Corp. L. 399, 418 (1979).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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